This Transcript has not been proof read or corrected. It is a working tool for the Tribunal for use in preparing its judgment. It will be placed on the Tribunal Website for readers to see how matters were conducted at the public hearing of these proceedings and is not to be relied on or cited in the context of any other proceedings. The Tribunal's judgment in this matter will be the final and definitive record.

IN THE COMPETITION APPEAL TRIBUNAL

Case No. 1299/1/3/18

Victoria House,
Bloomsbury Place,
London WC1A 2EB

25 June 2019

Before:

PETER FREEMAN CBE QC (Hon)
(Chairman)
TIM FRAZER
PROFESSOR DAVID ULPH CBE

(Sitting as a Tribunal in England and Wales)

BETWEEN:

ROYAL MAIL PLC — Appellant

- and -

OFFICE OF COMMUNICATIONS — Respondent

- and -

WHISTL — Intervener

Transcribed by ***OPUS 2 INTERNATIONAL LTD***
Official Court Reporters and Audio Transcribers
5 New Street Square, London EC4A 3BF
Tel: 020 7831 5627 Fax: 020 7831 7737
civil@opus2.com

HEARING – DAY 11

A P P E A R AN C E S

Mr Daniel Beard QC, Ms Ligia Osepciu and Ms Ciar McAndrew (instructed by Ashurst LLP) appeared on behalf of the Appellant.

Mr Josh Holmes QC, Ms Julianne Kerr Morrison and Mr Nikolaus Grubeck (instructed by Ofcom) appeared on behalf of the Respondent.

Mr Jon Turner QC, Mr Alan Bates and Ms Daisy MacKersie (instructed by Towerhouse LLP) appeared on behalf of the Intervener.

Tuesday, 25 June 2019

(10.30 am)

MR NEIL DRYDEN (called)

MR DAVID MATTHEW (called)

MR DAVID PARKER (called)

THE CHAIRMAN: Good morning. I can just see you there. I was referring to my barrier here.

Okay, so we're into the realm of concurrent evidence.

MR BEARD: We are. In terms of just the basic formalities for starting, each of the experts needs swearing and reference made to their reports in the ordinary course.

THE CHAIRMAN: They do. They need swearing. Can that be done, please.

(Witnesses affirmed)

MR BEARD: Mr Chairman, in front of the experts there is a concurrent expert evidence bundle. I don't know whether you want us to go through and have each expert confirm which are their reports and the authenticity of those reports. I'm very happy to do so in the ordinary way.

THE CHAIRMAN: Well, we're not cross-examining them on their reports. I think that is for later cross-examination. I'm quite happy to take the documents that have been submitted as they are and to conduct our concurrent evidence on that basis.

MR BEARD: I'm very grateful.

THE CHAIRMAN: Right.

In the meantime, Mr Beard while you're on your feet, I gather there has been some exchange about recent documents, late documents. Is there any point you want to make on that?

MR BEARD: Well, late last night Ofcom sent a letter after the close of the factual evidence enclosing four documents, three of which were from the case file albeit not in the trial bundle, one of which was not even on the case file. They made certain submissions in relation to those. I believe that the solicitors for Royal Mail have responded this morning asking on what basis it can be right that material is put in that was not in the trial bundle subsequent to the closure of evidence, in particular material that wasn't even on the case file, highlighting concerns about completeness of evidence, and also noting that the suggestion by Ofcom that in providing these four documents it is somehow providing all relevant material available to it is not a submission that was accepted.

In the circumstances Royal Mail considers that it's not appropriate for the tribunal to be referring to that letter or the material enclosed in it, but the arguments are set out in the letter of this morning.

It's a remarkable and highly unusual idea that after the close of evidence there should be the submission of further material of any sort in these circumstances. If Mr Holmes wishes to seek to adduce material that wasn't available to be put before the witnesses or hadn't been relied upon, those are matters he can raise of course in closing, but the idea that matters that were being traversed in cross-examination should be the subject of a round of written submissions afterwards is, to say the least, unusual, and we say is not an appropriate or fair course in these proceedings.

THE CHAIRMAN: Well, we have an infinitely flexible approach to procedural matters, but there are limits.

Mr Holmes, is there anything you want to say, because I'm not going to decide it now.

MR HOLMES: Yes, sir, there is, I'm grateful. We provided the documents because we wanted the tribunal to decide this case on a fully informed basis. The documents shed light on propositions which were put, factual assertions that were made by Mr Beard during the course of cross-examination. The documents are directly relevant to that. Three of the four documents are on the case file. It's not clear which witness it's suggested these documents should have been put to, but they all shed light on the matters that were traversed for the first time by Mr Beard during his cross-examination and we say that the appropriate course is for the tribunal to consider that evidence; if there are any submissions to be made that there's been any unfairness, they can be made and the tribunal can weigh the evidence. But there's certainly no basis for the tribunal not having regard to the documents insofar as they're relevant to matters that arise in the case.

Among other matters, you'll see that the only document that was not on the case file concerns -- it was an internal Ofcom exchange which showed that contrary to the suggestion made by Royal Mail's counsel that the previous CEO of Ofcom had behaved inappropriately, he had in fact behaved perfectly properly and had given advance notice to both of the parties of the decision that was forthcoming, and in our submission it's appropriate that the tribunal should consider these materials insofar as that's relevant.

THE CHAIRMAN: Well, that's very much for us to decide. I think I'd like to see the correspondence before we take a view on this.

MR BEARD: I'm grateful.

MR HOLMES: I'm grateful.

THE CHAIRMAN: Right, anything else of a procedural nature?

MR BEARD: I don't believe so.

Questions by THE TRIBUNAL

THE CHAIRMAN: Then we can get on to substance, can we?

Well, first of all, thank you, insofar as I can see you through this array of electronic aids, thank you very much for agreeing to do this, it's very helpful. We certainly take this process very seriously, we've allocated two days for it and we are keen to explore the economic issues of the case and to see what measure of agreement there is amongst the three of you and to see what the areas of disagreement are. We have done these concurrent evidence procedures before; they work, in our experience, we find them valuable, I hope you will. It doesn't of course preclude subsequent cross-examination in the normal way.

The questioning is going to be conducted -- or going to be led by Professor Ulph and we have set out the mechanism we want to use, the rough order in which you will be asked things and how you will be then asked further things by us. We'll try and stick to that as much as we can, but we are trying to get a proper discussion, we're not trying to micro-manage it. We would like to cover the issues we've set out. If I feel we're not covering them, I shall say so, but otherwise I'm content to let this work in a pragmatic way.

So Professor Ulph. Over to you.

PROFESSOR ULPH: Thank you. Good morning. As you will have seen from the agenda, a lot of the questions relate to the use of the as-efficient-competitor test, or the AEC test, which is one of the central issues in this case, but there are also some other questions relating to another important issue, that of price discrimination.

What I plan to do is I plan to work through the questions in roughly the order you have them but not exactly in the same order that you have them, because in preparing for the hot tub, I have sometimes grouped the questions in a slightly different way. I will be elaborating on certain points, I may ask some follow-up questions. I've also tried to clarify some of the wording of some of the questions.

So there are going to be roughly four groups of questions I'm going to ask you about. The first is a set of general issues relating to the as-efficient-competitor test but not related to this particular case. The second is a set of general issues of principle about whether or how you might do the as-efficient-competitor test in this particular case. And then I'll ask you some questions about how the as-efficient-competitor test was actually conducted in this case. Then finally we'll come to questions of price discrimination.

Okay? So can we get under way? So as I said, the first set of questions are about high level issues around the use of an as-efficient-competitor test and they're not specifically related to this case.

The first question I want to ask is: in what circumstances does the entry of a less efficient competitor increase consumer welfare? Mr Matthew, do you want to start off?

MR MATTHEW: Thank you, yes. So I approached this in a -- in the way that I set out broadly in my report. So we have a question here is when do we actually want less efficient competitors in the market, when is it a good thing? And I think my answer is it's a good thing where it increases competitive intensity.

So the entrant comes in, we have more competitive intensity and then you get the good things that flow from competition. And that, I think, gives you a general presumption that where entry can be achieved, you know, without stopping anybody else doing anything, that, broadly speaking, is presumptively a good thing, and that's why competition authorities when they do market studies, for example, will say, "If I have a practice that's artificially raising the barriers to entry, I don't want to see those because I want to see as much entry as I can get", and they don't sort of distinguish between whether the potential entrants are any particular level of efficiency, you just want the competitive process to be working.

So my view is entry that occurs where you're not placing restrictions on anybody from competing vigorously is presumptively desirable in the large majority of cases. The problem, of course, arises when you have the situation that can occur in foreclosure cases where the dominant firm of course can potentially cut its prices, offer good quality products etc, and that very competition can make it hard for entrants to come in. But that competition, when the dominant firm's doing those things, it is adding to the intensity of competition you get in the market, at least prospectively.

So what we don't want to do is to see artificial restrictions on the dominant firm's ability to compete, because then, yes, we might get more entry that way, but overall the competition in the market could actually be substantially lessened. Usually the dominant firm is the biggest player. If it's restricted from competing, that means the whole market may end up with high prices.

So I take a broad view. I mean, essentially, as long as entry is achieved without placing restrictions on the ability of a dominant firm to compete vigorously, then that entry is desirable.

PROFESSOR ULPH: Okay.

Mr Parker?

THE CHAIRMAN: I think Mr Dryden next.

PROFESSOR ULPH: So Mr Dryden.

MR DRYDEN: Thank you. So inefficient entry is a source of productive inefficiency. So total industry costs will be higher and that's a source of upward pricing pressure. Consumers will be better off if that upward pricing pressure from productive inefficiency is outweighed by allocative efficiency and dynamic efficiency. So allocative efficiency is the effect of competition in reducing the margins above the level of costs and dynamic efficiency is the process of competition reducing costs in the medium to long term.

So the dynamic bit is over a different time horizon. So just focusing on productive allocative efficiency, the short answer to the question I think is that the upward effect on costs has to be outweighed by the margin supplied above that level of costs coming down as a result of competition.

There is just one nuance, if I may, on the answer, which is there are two different scenarios in which we can think of this question. One is just entry in the normal course, if I can put it that way. The second is entry under a regulatory regime that has created a headroom for an inefficient entrant to come in, and one sees the concern expressed in the literature that creating some headroom for an inefficient entrant to come in may actually affect the efficiency of the entrant. So in other words their efficiency isn't completely exogenous, it can become dependent on the regulatory regime because their incentive to be efficient is reduced by the fact they are being credited with some headroom.

So the answer is slightly different in the ordinary course answer and in the regulatory regime.

PROFESSOR ULPH: Thank you. Mr Parker?

MR PARKER: Thank you. So I think I'm in a similar place, which is there are three effects from entry. There's allocative efficiency price competition benefits, there are static cost effects potentially which would lead to some upwards pricing pressure, allocative efficiency of course listed down in pricing pressure, and there's dynamic efficiencies whereby the process of competition generates cost incentives to reduce costs across the board, and I think it's a balance of those factors.

I think one area to point to is that if you have a situation where there's a monopoly, the monopoly will be pricing at a level well above the static costs and therefore if the entrant can come in at a level that's with costs that are below the monopolist's price, that allows it to charge a price that is below the monopolist's price and that gives rise to consumer welfare benefits because at that point consumers are getting a better price, yes industry costs might go up to some extent but the inefficient entrant is really squeezing the margins of the monopolist. So Professor Salop in the paper we've discussed at some length makes that point as being the relevant efficiency criteria.

PROFESSOR ULPH: I think that's also a point that you make, Mr Matthew, in your report, that if you have a monopoly position and you have an entrant coming in, even if the entrant is less efficient than the existing incumbent, as long as the entrant's costs are below the monopoly price, first of all that guarantees the entrant can survive and secondly guarantees the price will come down and considerable benefit; is that your position?

MR MATTHEW: That is, and it's -- yes, that situation is efficient entry even though the entrant itself is less productive than the incumbent.

I think it has a slightly more general application as well, so I just wonder if I can make a comment on the observations. So both of my colleagues argued that when you get duplication of fixed costs that results in upward pricing pressure. That's not the presumption that usually arises. I mean, it might be an entrant comes in -- sorry, the process usually works, an entrant comes in incurring additional fixed costs, so yes it does lead to fixed cost duplication, but the entrant comes in and by coming in it prompts an increase in competition in the market. So you expect downward pressure on prices, not upward pressure.

It may be that downward pressure is sufficient to mean the entrant didn't have a profitable entry opportunity, in which case it either won't come in or it will come in and then shortly leave thereafter, but it's not the case that somebody coming in duplicating fixed costs in itself leads to upward pricing pressure in markets. Actually the effect is the other way round.

PROFESSOR ULPH: Any further comments?

MR DRYDEN: Yes, so we're still at the level of principle in the application.

PROFESSOR ULPH: Yes.

THE CHAIRMAN: We're going to stay at a level of principle for as long as we need to, Mr Dryden.

MR DRYDEN: Understood. I think it's an empirical matter and it comes down to the facts that we will in due course have to come to. I don't think it can be presumed that inefficient entry of any degree will be outweighed by allocative efficiency even in the case of a monopoly, and the short reason for that is if the monopoly is reasonably close to its break-even constraint, in other words reasonably close to the point where its total revenues cover its total costs, then the scope for allocative efficiency is rather limited.

In other words, if we increase total industry costs, they have to be recovered from somewhere, and if it -- you know, if margins are not too great they will have to be recovered through higher prices.

PROFESSOR ULPH: So we seem to have some element of agreement that under some circumstances if you start off with a position of monopoly, entry even by a less efficient competitor can be beneficial. But you have a concern that in the very long run you may have to raise prices and that could be harmful.

MR DRYDEN: I agree with the summary other than the limitation to the very long run.

PROFESSOR ULPH: Okay.

MR FRAZER: Could I just ask at that point. Mr Dryden I'm not quite sure I understood that you answered whether there are circumstances in which the entry by an inefficient competitor could increase consumer welfare. I understood you indicated a number of circumstances when it wouldn't or might not.

MR DRYDEN: Yes.

MR FRAZER: Can you tell us if you believe there are circumstances in which an inefficient entry would benefit consumer welfare.

MR DRYDEN: Certainly it's possible and I've, you know, tried to say that from -- from the outset. So my point is it might be the case that it does and it might be the case that it doesn't.

MR FRAZER: But in what circumstances might it be the case that it does?

MR DRYDEN: Well, the -- in sort of sticking to abstract terms, the allocative efficiency, so that downward pricing pressure from reducing margins, would need to outweigh the increase in costs which by definition are happening when we have inefficient entry. So the downward pricing pressure has to exceed the upward pricing pressure. And then to that we can add dynamics but that's -- that's over the long term. And that balancing is, even in the case of monopoly, is going to be an empirical issue and cannot in my view be a matter of presumption.

THE CHAIRMAN: When you say something is empirical, you mean, am I right, there is actually no great disagreement of principle that in some circumstances entry that you would categorise as less efficient can benefit competition, but it all depends on the circumstances of the case; is that -- could we get agreement to that proposition?

MR DRYDEN: From my side, I -- I agree with that. I think we were -- strictly we were answering about the impact on consumer welfare rather than competition, but I agree.

THE CHAIRMAN: I'm just playing lawyer. I gather that they are interchangeable sometimes. Maybe not.

MR DRYDEN: Yes.

THE CHAIRMAN: I think Mr Matthew wants to make one further point.

MR MATTHEW: Sorry, is it okay to -- I mean, stop me if I'm asking again. I just wanted to clarify a point because I think it's a significant one in this case. So my comments are about where we have a single product and a single market and we're asking the question when is entry desirable in competition in this market, and the situation Mr Dryden describes is one where the monopolist can only just cover its costs in that market and therefore entry will duplicate fixed costs and no one can survive and that would be right but for that reason you wouldn't get entry in a market like that.

I think the main theme coming out, however, which it is important to bring out, is that those observations relate to where we're talking about one product, one market. I mean, of course, in this case, the main point that Mr Dryden refers to is the fact we have a single network --

THE CHAIRMAN: I don't want to stop you Mr Matthew but we're going to get on to that. What we're trying to do is just the basic position, a level of broad principle, because one could otherwise be forgiven from some of the earlier exchanges that there's a fundamental disagreement about whether less efficient entry can ever be beneficial, and I think we've resolved that.

PROFESSOR ULPH: Okay, I'll move on to the second question. It relates to what we've just been talking about. I want to clarify this whole issue about the link between productive efficiency and consumer welfare, because you've all talked about three types of efficiency, productive efficiency, allocative efficiency and dynamic efficiency. The question I want to ask is: is productive efficiency necessarily a concern when we're considering consumer welfare?

The case I have in mind is I think the case that Mr Matthew is referring to. Supposing you have entry into an industry that is duplicating fixed costs of entry into that industry. That will typically reduce productive efficiency, but it may increase consumer welfare. So you're trading off a loss of productive efficiency against a gain in consumer welfare. So the question I would like to put to you is: is it always the case that productive efficiency enhances consumer welfare, Mr Dryden?

MR DRYDEN: No, but I think it's sometimes the case that it does, so it comes back to my view that these things can't be settled at the level of principle and we'll have to come to the facts. And the reason productive efficiency can matter is that as economists we tend to spend a lot of time thinking about the relationship between prices and marginal costs or incremental costs and suchlike. But there is always another factor at play which is the firm has to satisfy its break-even constraint. So total costs have to be recovered.

So if we have inefficient entry, by definition, total industry costs are increasing and those industry costs have to be recovered for the participants in the market to satisfy their respective break-even constraints, and that could mean that prices have to be higher for the reasons that I gave earlier, because there may not be sufficient scope for allocative efficiency to more than outweigh the upward pricing pressure.

PROFESSOR ULPH: But couldn't that also trigger a process of exit? If you're not recovering all the revenue -- sorry, if you're not recovering all the costs, wouldn't that drive exit?

MR DRYDEN: Well, it could, and arguably maybe it did.

PROFESSOR ULPH: Okay.

Mr Parker?

MR PARKER: So I think the relevant questions for productive efficiency at least in the short term are if the consequence of entry is that marginal costs increase, so there are increases, then that would be expected to feed through into upwards pricing pressure because if some level of costs pass through, common models of oligopoly would suggest that when costs go up prices go up to some extent, and that is the factor that would then need to be outweighed, you know placed in the balance with the price benefits of allocative efficiency and increased competition.

PROFESSOR ULPH: Okay, thank you.

MR MATTHEW: Well, it is the answer I gave recently.

Firstly, not referring to Mr Parker's point, models of oligopoly will tell you if the firms in the market can profitably survive in it, they will lead to downward pressure on prices, and that is true even if the marginal firm joining has higher costs than everybody else. If it can survive it's going to create downward pressure, that's what you would expect. So that's the point I made before.

Yes, essentially I agree with the characterisation of the way you put it. The case is not we duplicated fixed costs so we're not making profits so prices have to go up. I mean, that's an argument for cartel arrangements or others that allow you to artificially keep the prices high in order to survive. But the more natural process is somebody leaves in that situation.

PROFESSOR ULPH: Is the issue here also that we're thinking of production efficiency? That's certainly relevant when we're using a total welfare standard that looks at both producer surplus and consumer surplus. It's just not clear why it's relevant if we're focusing just on consumer. It's clearly relevant for a total welfare standard, but is it always relevant for consumer welfare? I think that's what we're trying to get at.

MR DRYDEN: Again, I'm sorry to repeat myself. The answer is: not always, but neither is it never.

PROFESSOR ULPH: Okay.

MR DRYDEN: For the reasons I've given.

THE CHAIRMAN: Not sometimes then?

MR DRYDEN: So I can positively say sometimes.

Just for a reference on this, Professor Vickers' 2005 article which I think has been provided deals with -- he is proceeding on a consumer welfare standard and he deals with productive and allocative efficiency and says the first may outweigh the second or the second may outweigh the first. So it's not a -- it's -- it's a sometimes thing and it is so even under a consumer welfare standard.

PROFESSOR ULPH: Okay. But it is naturally, a total welfare standard would naturally include productive efficiency.

MR MATTHEW: Yes, if you use the total welfare standards clearly you need to trade off the gains to consumers that arise with the loss of profits to the producers, and, you know, that could -- could result in a negative effect. That's general in the economy. I mean, we get duplication of fixed costs all the time and ...

MR FRAZER: I just want to pick up something that Mr Parker was saying. You have placed some reliance on Professor Salop's article in your submissions and you mentioned him again today. To what extent is he helpful in your view to this Tribunal in the sense that he is operating within the context of a very different legal system with different standards of proof and different types of inquiry, rule of reason for example, doesn't deal with margin squeeze or price discrimination, and in a context in which price discrimination is in fact dealt with in a different statute and in a very different way. I just want to understand from you the extent to which we should be looking to Professor Salop for help in relation to the approach in the -- not necessarily in this case, but in general cases within our own legal system.

MR PARKER: Well, from a legal perspective I'm obviously in your hands. From an economic perspective, and I think -- I suspect we will come to this later, but what I think Professor Salop is doing is setting out quite a general economic approach to different types of exclusionary abuse, or if you like a way of separating competitive foreclosure from anti-competitive foreclosure, and from my perspective there are lots of -- it's a very useful framework whether you're thinking about this in a US context or whether you're thinking about it in a 102 or Chapter II context as we are here. So for me I think the economics are the same, I can go into more details on those now, but I suspect Professor Ulph will come to those. Obviously, from the law, that's -- that's for you.

Just in relation to does he talk about margin squeeze and price discrimination, I would suggest that all of these -- or there are certain types of exclusionary behaviour that could be wrapped up under the rubric of raising rivals' costs. I have observed in the joint statement that I think you could characterise the conduct at issue in this case in a variety of different ways.

So on the one hand, you could think about it as an example of price discrimination as between a 100% access operator and an end-to-end entrant. You could think about it as a conditional pricing practice, because subject to meeting certain conditions you achieve one price, whereas if you don't meet those conditions you achieve a higher price. You could think about it as fidelity rebate or loyalty rebate in the same way, and you could think about it as an example of raising rivals' costs, or you could think about it in terms of a horizontal margin squeeze, which I think would be differentiated from the classic margin squeeze cases that generally arise in the case law.

So given that, given there's a variety of different ways to characterise the conduct, I think Professor Salop's article and his framework from an economic perspective do for me capture some very salient points, but obviously from a matter of law, that's -- that's one for other people.

MR FRAZER: Just for the avoidance of doubt, I was asking from an economic perspective, so thank you for that.

MR MATTHEW: Sure.

THE CHAIRMAN: Yes, the law does appear to attach significance to these fine distinctions but we are concentrating on the economics.

Mr Dryden, do you have a comment on that?

MR DRYDEN: On the relevance of --

THE CHAIRMAN: No, on what Mr Parker's just said.

MR DRYDEN: It covered quite a lot of territory, sir.

THE CHAIRMAN: Yes.

MR DRYDEN: I think the question -- just to check, perhaps the question was the relevance of Professor Salop's article in economic terms.

THE CHAIRMAN: The question was should we be informed at a level of principle by a distinguished economist operating in a different jurisdiction which treats certain aspects of monopoly behaviour under a different framework. I think that's -- am I right?

MR FRAZER: Yes.

THE CHAIRMAN: That's the question. Are you with Mr Parker on that, or not?

MR DRYDEN: I think partly -- partly yes and partly no.

The -- there are I think two main points that I would like to make about Professor Salop's article. The first is that he says that he prefers a consumer welfare test as the objective test of conduct rather than the application of a price cost test. So what he would rather have us do is look at consumer welfare under the factual and then imagine a counter-factual in which the conduct wasn't present and consider what would be the level of consumer welfare there, and if consumer welfare is lower under the factual, the conduct would be deemed inappropriate. And he prefers that to the application of a price cost test. He's critical of a price cost test.

The price cost test that Professor Salop is dealing with in his article is not the as-efficient-competitor test, it is the sacrifice test, and I'm not sure thus far in these proceedings that has been clear in general, and including by those who rely on Salop. We can see that it's not an as-efficient-competitor test, because the first false negative that Professor Salop identifies in relation to using price cost tests is that an as-efficient-competitor could be excluded. And obviously an as-efficient-competitor cannot be excluded under the application of an as-efficient-competitor test. That's his very purpose.

The reason he is looking at a sacrifice test comes back to I think part of the origin of Mr Frazer's question, which is the Salop article is coming out of US jurisprudence and Professor Salop's critique of that and the particular test is a test of sacrifice from Brooke Group and in the US I think sacrifice has played a larger role and Professor Salop is critical of it.

I don't think it reads across to the EU context, because I think, you know, since the guidance and etc, the quest has been to look more for an objective standard of abuse and sacrifice has never had that prominence.

So point number one is Professor Salop's price cost test isn't the as-efficient-competitor test.

The second point is, if one accepts Professor Salop's presumption for doing a consumer welfare comparison, he says that unless it is a naked exclusionary act, and in other words if it is one that has potential benefits -- and I've outlined the potential benefits as I see it in terms of productive efficiency -- he says you must, that's his word, weigh. You have to weigh the benefits and the possible costs, the upward and the downward pricing pressure that I was talking about earlier. And that is -- you see that very nicely in the first paragraph on his section on cognisable competitive benefits, in that section.

And I'm saying that, you know, as you know my preference is to do an as-efficient-competitor test. If that were rejected and one goes down the Salop route of a consumer welfare comparison, I'm saying that weighing exercise has not been done in any meaningful way. The case has proceeded on the basis of presumption where I think if it had gone down that route, it should have proceeded on the basis of some weighing exercise.

THE CHAIRMAN: Mr Matthew I think should -- do you have a view on this?

MR MATTHEW: So on the general importance of Mr Salop, I mean, there may be issues around the technicalities of the differences in the price cost tests he's talking about that might make more sense in US jurisprudence. From memory, I thought the price cost test he was dealing with was similar to the incremental price cost test that Mr Dryden uses, but that's not my main take-away from Salop.

I think the general import of that article is what it's saying is when you're talking about predation you have a what he calls -- I think he calls it a very permissive test, which is predation is low pricing, we don't want to get in the way of low pricing. There is a concept of profit sacrifice floating around, ie dominant firms, when they give up profits to drive people out is what you're looking for, and the predation test, price below marginal cost is a test of profit sacrifice.

What he's saying in quite general terms is a reliance on very strict price cost tests in those circumstances shouldn't read across when you're talking about other types of behaviour where it's far less clear that they're presumptively desirable, and he obviously talks a lot about conditional penalties, conditional discounts and other such things as being the types of areas where you move to US rule of reason, which is what I think Mr Dryden means by weighing up the various different factors.

But the key point here is obviously you've moved away from the concept of a price cost test as a safe harbour. Once you're away from that, you look at that weighing up process, which is the all the circumstances assessment, as I see it.

THE CHAIRMAN: I think we'll come back to these issues.

MR FRAZER: Can I just ask one more?

PROFESSOR ULPH: The next question I want to ask is in what sense does the use of an as-efficient-competitor test ensure efficient entry?

Now, just before we proceed, I completely accept that passing an AEC test is a necessary condition for efficient entry, but it's not a sufficient condition for efficient entry. Is that something that you would all agree? Mr Parker?

MR PARKER: Yes. I mean, I think if you are -- if you pass -- sorry, who is passing this test?

PROFESSOR ULPH: You do a test, the test -- sorry, I'm thinking in this case of a competition authority does the test, finds it's passed and says that the action being taken by the dominant company is not excluding an as-efficient-competitor, therefore an as-efficient-competitor could enter. It was a necessary condition for efficient entry but it's not a sufficient condition because the test could be passed, there still could be some headroom that would allow inefficient entry to come in. That's the circumstance I have in mind.

MR PARKER: Yes, so I think maybe playing it back a different way and seeing if this -- see if this is what I understand by the question. If you -- if you do an as-efficient-competitor test and you look at a rival that is fully as efficient as the incumbent, if you carry out the test and say, "Well, an entrant that is as efficient by, as the -- as the incumbent would be excluded" -- let's do this the other way round --

I think you can, subject to a handful of minor exceptions, but subject to those fairly unlikely to apply exceptions, you can say that's a definite fail, you know, that's -- that's a definite problem because the -- the incumbent has managed to foreclose on an as-efficient entrant.

If the test is passed, then it seems to me from the perspective of consumer welfare, you would want to build in some -- there are entrants who could enter who are slightly less efficient than the incumbent but who will nonetheless benefit consumer welfare and therefore drawing the line at the AEC -- at a sort of very pure AECT I'm not sure is sensible from a consumer welfare perspective.

Does that -- have I interpreted your question correctly?

PROFESSOR ULPH: Yes. That was the point I was making. If it's failed, then you know you're excluding an as-efficient entrant. If it's passed, then it's a sufficient condition for as-efficient entry, but it could allow inefficient entry as well.

MR PARKER: If it's passed it could allow inefficient entry which could enhance consumer welfare; yes, that's what I would say.

MR DRYDEN: Yes, I agree with the summary as Professor Ulph just put it. Sorry, I should say, there's two versions of pass. There's just passed, in other words the pricing just satisfies the as-efficient-competitor test. Then there's a more general sense of pass which could include --

PROFESSOR ULPH: A margin.

MR DRYDEN: -- passing with a margin. So in the first case, just passed, the as-efficient-competitor can come in profitably but any inefficient entrant cannot. In the scenario where it's passed with the margin, as before, efficient entrants can come in but a degree of inefficient entry is also permitted.

PROFESSOR ULPH: Mr Matthew?

MR MATTHEW: I mean, clearly if the test is passed but it's just binding, so it's priced at AEC, then you will prevent some entry that could have been beneficial for consumers.

PROFESSOR ULPH: Okay, but the next question I want to move towards, thinking more about actual entry decisions by firms. So supposing you have an industry where there's a dominant firm, a dominant firm might weigh up the potential entry by taking a potentially foreclosing action. If it takes the action, then that will be examined by the competition authority and the competition authority will use an as-efficient-competitor test to determine whether or not the action is genuinely foreclosing. I know as economists we make lots of assumptions, so I have made lots of assumptions there.

So my first question is, in those circumstances, might it still be rational for a less efficient competitor to contemplate entering that industry?

Mr Dryden?

MR DRYDEN: The way that I tend to think of the efficiency of the entrant is -- is taking account of their kind of efficiency gains over time. So one could think of the NPV of their efficiency, and they may have non-cost advantages. So you can think of quality adjusted efficiency etc. So if we're thinking of a measure of the entrant's efficiency that has all of those things built in, then you would expect entry -- and if the as-efficient-competitor test is only just passed, you would expect entry only by a firm that is as efficient in that sense and not otherwise.

If, on the other hand, the scenario is that the as-efficient-competitor test is just passed and we're taking a more -- narrower view of what entrant efficiency means and it's the productive efficiency of the entrant today and they're less efficient today, such a firm may choose to enter because it may anticipate that over time it will get more efficient, or it may have some value proposition that is worth more to consumers than the cost disadvantage that outweighs it.

So I think my answer to the question depends on the scope of how one's defined efficiency in the first place. But the point is that the as-efficient-competitor test sets from the point of view of the kind of more encompassing view of efficiency the right benchmark for getting the entry that is efficient or not, setting aside allocative efficiency.

PROFESSOR ULPH: Right. Mr Parker?

MR PARKER: I think I'd have a slightly different view. So let's suppose I'm an incumbent and I have the possibility of foreclosing a rival as long as I pass the as-efficient-competitor test and I know that the competition authority will carry out such a test. If I was a less efficient entrant I would think, "Well, I don't think I can enter here because I know that the dominant firm would be allowed to foreclose me because then on the as-efficient-competitor basis the test would be passed and if that's the determinative test, I wouldn't take -- take the risk.

So it seems to me that, you know, that would then lose the potential for price competition, allocative efficiency and indeed for long-term dynamic efficiency because it would give the incumbent quite a lot of flexibility in what it chose to do, and clearly it would be in incumbent's interests to foreclose as much entry as it was allowed to do under competition law.

PROFESSOR ULPH: So is your answer that under those circumstances any inefficient entry would be foreclosed because the incumbent could always choose the level of foreclosing action such that the test was just passed?

MR PARKER: Let's say we have a clear bright line at as-efficient-competitor and you knew, total certainty, you see elsewhere in the case, that that test would be applied and you have total confidence on what the sort of inputs to that were, then if I was to some extent less efficient, then I think I would not enter because I would know that it would be within the scope for the incumbent to foreclose me, and it would clearly be the -- it would be the incentive of the incumbent to foreclose me because it's always better to have less competition than more from a monopolist perspective.

PROFESSOR ULPH: Mr Matthew?

MR MATTHEW: On that I think there's an important prior we need to think about, which is what is the way in which the incumbent is going to try to foreclose entry. So if we think of let's call it vigorous competition, cutting your price, although the incumbent may be allowed to price down to AEC cost levels, often it will be too costly for it. So the incumbent is setting a monopoly price to start with, it cuts its price, it loses profits on a -- on the entire market and that's a very costly thing to do, and that's why many economists have said actually, you know what, in a lot of cases predation isn't -- isn't a viable strategy. You could do it but it's just far too costly so you don't have incentives to do it.

And in practice what happens is incumbents faced with entrants who have the possibility of coming in will often -- they'll accommodate entry not because you force them to but because they're better off saying, "Right, okay, we're going to have some competition but I'm better off with that than taking on board the huge costs in the short run".

And that's part of why price cost tests are a useful predation. It's partly because that's often not going to be a viable strategy, so by adopting quite a permissive approach you're balancing between not chilling dominant firms from setting low prices against a really quite small probability when you get predatory behaviour which will foreclose competition that would have actually in the long run led to benefit.

If however the strategy is I've got another weapon so I can relatively costly raise my rival's costs or otherwise threaten to do that, it doesn't cost the incumbent in the short run and then the entrant knows well that almost certainly is going to be deployed against me, then the AEC test will prevent any inefficient entrants coming in, but obviously we say -- I say that's a problematic line to take.

MR PARKER: I should just clarify my remarks were in the context of the second type of strategy that Mr Matthew talked about, ie raising rivals' cost strategy.

PROFESSOR ULPH: Just one question to ask on this. This kind of presupposes you have really extremely rational incumbents who can calculate to the last decimal place how effectively they can calibrate their action and know how the competition authority will assess the action. If there are some errors in there, so they take an action, they're not quite sure whether it's going to be passing or fulfilling the as-efficient-competitor test, does that create some leeway for less efficient competitors to come in?

MR MATTHEW: Well it creates a probabilistic situation. So we have action that might or might not be found to be guilty and the dominant firm weighs up those probabilities, and I guess if a dominant firm is risk averse it may alter its perception of those probabilities, but I don't think it fundamentally alters the points. I mean, essentially it will take a view as to what its expected risk is, exposure is, and take a view on that basis. Many things in commercial life are not certain. Most.

MR DRYDEN: I just wanted to answer the previous question because I have tried to come in at the end there because I think I answered it on a different basis to the other experts; because I think the question was about the entrant anticipating that the incumbent in the future might price down to the as-efficient-competitor test, but it seems to me that that isn't a question that is particular to the as-efficient-competitor test.

If the point is that there is an objective standard by which -- which governs how aggressively the incumbent can compete, then whatever that standard is, whether it's as-efficient-competitor test, a consumer welfare test, a SLEO test or etc, if the incumbent today is not pricing down to the point of just satisfying that test but has allowed some margin, then, as Mr Parker put it, if the entrant anticipates with kind of probability 1 that the incumbent may do that in the future, then that could discourage their entry, but then provided the test was right in the first place, whatever test it is, that would be the -- that would be the right outcome.

MR PARKER: I mean I think we could perhaps distinguish between -- we've got two paradigms here. There is a low pricing approach which I think is what Mr Dryden was just talking about, and we've got a raising rivals' costs approach which I think myself and Mr Matthew are talking about, and that if you like is the distinction Professor Salop draws in his article as to under what circumstances should one use an ACT or not.

MR DRYDEN: No, with respect --

MR PARKER: That's not correct?

MR DRYDEN: -- that's not right. I was saying whatever the test is, whatever the test is, the objective standard is, if the entrant anticipates its application in the future and under it -- sorry, anticipates the dominant company just satisfying that test, whatever it is, in the future, and if it knows under -- in a scenario where the incumbent just satisfies that test, whatever it is, if the entrant believes in that world it wouldn't be profitable, then that could discourage its entry. So I'm trying to answer at a level of generality that it doesn't depend on what the test is.

PROFESSOR ULPH: This is a general conclusion then that whatever test you use, as long as the incumbent knows what tests are being done and he chooses his action appropriately, then less efficient competitors typically will be deterred; is that the conclusion that you're all coming to?

THE CHAIRMAN: I'm very puzzled now, I must say, speaking from my non-economic perspective. We're talking about an as-efficient-competitor test. We're going to get on, I think -- I hope -- to what we actually mean by that. But let's take it as a given concept. I thought the situation we were discussing was where, if that test is applicable and there is a potential entrant who is -- who could satisfy it, they might still be deterred by the anticipation of further reactive conduct by the incumbent and I think you were saying, Mr Dryden, that that applies to any test, in that you can pass a test but the incumbent may still have leeway to react and to make your entry very unattractive.

But isn't the distinction that we're actually between the as-efficient-competitor test and other tests -- we don't know what they are, but let's assume there is a whole string of them -- we're actually trying to find a test which relates to efficiency, so it seems rather odd if it actually operates to deter some element of efficient entry. That's -- that's what puzzles me.

MR DRYDEN: Okay, let me have another go. If the scenario is that we assume for present purposes the as-efficient-competitor test is the correct test, and if we assume that even if it's not doing so today the dominant company may price at a level that only just satisfies that test in the future, but in all future scenarios it will always provide a margin that satisfies the as-efficient-competitor test, then --

THE CHAIRMAN: But it's not pricing at that just level at the time you applied the test.

MR DRYDEN: But above. Right; so in that scenario, an as-efficient entrant would enter and it would obviously prefer that there remains a margin in the future but it would still know that it would be profitable and want to be in the market even if the entrant became more aggressive and only just satisfied the test in the future. So the as-efficient-competitor would choose to enter.

The inefficient entrant would bear a risk, which is they would be gambling on the dominant company maintaining a margin above the test that is sufficient for the entrant to remain profitable in the future and they would be exposed to the risk that the entrant -- the incumbent, I'm sorry, properly in this scenario would choose to price down to just satisfy the --

THE CHAIRMAN: No, I understood that, but I thought you were extending that to the efficient entrant also being open to that kind of later conduct.

MR DRYDEN: No, I'm --
THE CHAIRMAN: No, you're not.
MR DRYDEN: Forgive me if I was unclear on that. My point is in fact the opposite.
MR FRAZER: So is the answer that the as-efficient-competitor test is designed to determine whether the incumbent is excluding efficient competitor rather than trying to determine whether it's permitting an inefficient competitor to enter?
MR DRYDEN: Precisely.
THE CHAIRMAN: Shall we move on?
PROFESSOR ULPH: So the next question I want to ask is, as a matter of economic principle, how would you distinguish foreclosure and anti-competitive foreclosure?
Mr Matthew?
MR MATTHEW: I'll have first go. Let me just say I think it's quite difficult to come up with a singular concise definition so I'm going to approach it in -- I'm essentially going to set out two things that I think are relevant here and I'm not going to say that they apply to all cases that might -- might arise. So I think of -- I mean, I go back to the textbooks and think of what do economists mean when they mean anti-competitive foreclosure? So this may well differ from legal

meanings but what are they -- what are people worried about? The classic would be where a firm, usually a monopolist, let's assume it is a monopolist, or a dominant firm, does something not because it's the most profitable thing it could be doing faced with the various competitive and other market constraints it faces at the time, but does it because it believes that it will lead to one of those or more of its competitors leaving the market, or not entering the market, such that down the line they will retain a larger position of market power which they can exploit and set high prices.

That for me is probably the textbook one, and that's why in the economic literature such as the US you see a lot about profit sacrifice because what they have in mind there is a concept that says if a dominant firm is incurring a profit sacrifice, which means it's doing something that defeats it in the short term, it must be doing that because it's driving somebody out and it's going to gain in the long term. So that's sort of the textbook.

But I think there's a broader category, and we talked about raising rivals' costs, but I think more generally that sort of textbook exclusion is often hard to find in real life. I think in this case we actually are seeing this but generally that's not what these cases are usually dealing with. Often competitors aren't going to be excluded entirely, it's difficult to say precisely that there's going to be a long-term gain, but there will be some types of conduct that raise rivals' costs and these are things that essentially a dominant firm might do that make it -- make the rivals less able to compete. So -- and I contrast that with the dominant firm itself competing.

So to me, a dominant firm competitively foreclosing, if you like, if that's the outcome, would be one that cuts its prices. One that raises rivals' costs and says, "For various reasons I've got the power to tax you, to put a penalty on your ability to compete". That is also anti-competitive foreclosure, and that's -- so those are the two that are most relevant to this case but that's sort of how I think about it.

PROFESSOR ULPH: Okay. Mr Parker?

MR PARKER: Yes, I think, as Mr Matthew alluded, it's a big question. I'm definitely in a similar place. I think -- so if you think of foreclosure generally as being actions that hamper the ability of rivals to compete --

THE CHAIRMAN: Sorry, I didn't hear that.

MR PARKER: Sorry, foreclosure is being actions that hamper the ability of rivals to compete and make profits, and the relevant issue is there are some actions which are meritorious and are pro-competitive and pro-consumer such as cutting your prices to try and compete more effectively where those have direct consumer benefits.

Our concern in those circumstances is that we are worried in a world where there is if you like excessive competition on the part of the dominant incumbent so that any rival can't compete against that excessive level of competition, and AECTs, or price cost tests generally, are often used in those circumstances because they give you a guiding line as to when does good competition in terms of low prices become excessive competition in terms of predation or similar. The concept of profit sacrifice is very similar to -- is sort of in that spirit.

Then the second set of alternatives is I think largely raising rivals' costs strategies where for whatever reason the dominant incumbent has the ability to raise the costs of its -- any potential rival by virtue of the dominant position that it finds itself in.

So I think this is -- this is one example. You have to purchase access from the dominant incumbent if you're an entrant and so the dominant incumbent has control essentially of the -- of the rivals' costs. In that category, you don't have any obvious consumer benefit arising from that behaviour. So that's just putting prices up to -- prices up to your rivals in that circumstance.

Another example would be let's suppose there's a certain input that's available and there are three firms that provide that input and the entrant needs that input to survive. The dominant incumbent could strike exclusive deals with all of the -- all of the input providers so that an entrant then would not have any -- any ability to get that input or any substitute would be on far worse and less effective terms, for example. So the idea is that doesn't necessarily give rise to any consumer benefit, it doesn't give rise to any profit sacrifice, but nonetheless it gives rise to an anti-competitive foreclosing effect.

So those are the two -- the two sort of canonical(?) types I think of exclusionary abuse and that's very much the approach that Professor Salop takes in his paper. So just to give you a sense of where to look there.

PROFESSOR ULPH: Okay.

Mr Dryden?

MR DRYDEN: I think the narrow question was, you know, as a matter of principle how do we distinguish foreclosure from anti-competitive foreclosure. I agree with Mr Matthew's opening remark that it's difficult. Professor Vickers in his two articles, the 2005 and the 2007 one, says it's less than clear, he says it's surprisingly difficult, and he describes a quest for the answer.

THE CHAIRMAN: If John Vickers says something is less than clear we ought to be worried.

MR DRYDEN: Indeed. And what he does expressly and what I think happens in reality is that scholars and practitioners dwell for a little time on this question of what is the distinction as a matter of principle, conclude that it is less than clear, and then the debate shifts to choosing between tests -- objective tests. And that's not ideal because we prefer to have an absolutely clear principle that would define the test. The reality I think is the principle is not completely clear and so we look at tests and think about their respective pros and cons. And the three tests that are most often canvassed as objective tests are the sacrifice test, the as-efficient-competitor test possibly with the less efficient modification, and thirdly the consumer welfare test.

So principle not very clear, the debate moves to thinking about the pros and cons of different objective tests, and in large part that's, you know, the issue that we face in this case.

Just to pick up, if I may, on what the other experts said. I got the impression from what Mr Matthew said that it was kind of sufficient to his mind that he observed some what he characterises as raising rivals' costs, didn't conclude that there's a problem. And Mr Parker said in terms there is no obvious consumer benefit.

But going back to the beginning of this session, I completely disagree with that. There is a light side as well as a suggested dark side to the conduct, and the light side is keeping total industry costs down in a situation of extremely high fixed costs and falling volumes and limited scope for allocative efficiency to fund a duplication of fixed costs.

Again, forgive me for referring so heavily to Professor Vickers but the 2007 article has got a nice paragraph on fixed costs and he says there that pricing conduct that drives loyalty -- and I think he's thinking there about rebates but it's more general -- pricing conduct that drives customer loyalty to the dominant firm in the context of high fixed costs can be a good thing because it reduces the average cost and allows the dominant firm to charge a lower price. But it can also be exclusionary.

So he says, just from seeing conduct that induces loyalty and the dominant company getting volumes for itself, that's not enough to say that it's good or bad, it's an empirical question about whether -- an empirical question about consumers. So I reject the kind of presumption point which has crept in again and which in my view is misplaced.

Finally, Mr Matthew makes a distinction that I think is a very important element of his analysis between sort of low pricing cases and not low pricing cases, and he puts this case in the not low pricing bucket. Somewhat analogously perhaps Mr Parker has these buckets of kind of raising rivals' costs and other cases, and he says the as-efficient-competitor test is not applied in the raising rival costs bucket. I think I would just like to -- I mean I can either deal with it now or just put down a marker.

THE CHAIRMAN: I think put down a marker.

MR DRYDEN: Then I think those distinctions are problematic. The suggestion that the as-efficient-competitor test is not applied in what are being characterised as raising rivals' costs cases I think is factually wrong, and I think we will have to come back to that.

THE CHAIRMAN: We shall. We most certainly shall. This is a time to pause, I think. We'll pause for 10 minutes if we may.

(11.43 am)

(A short break)

(11.55 am)

THE CHAIRMAN: They've moved a bit of paraphernalia and we can now see you better than before.

I think the intention in this session is to come a little bit more down to earth if that's fair, or maybe down to a slightly lower level of whatever is above us.

But before we do that, Mr Frazer has one clarificatory question.

MR FRAZER: Just a question arising from a question before the short break to Mr Matthew and Mr Parker. You were very clear in distinguishing between anti-competitive foreclosure and foreclosure but I wasn't quite sure what your tests would be where as-efficient-competitor test is not either appropriate or available. How do you test for that distinction?

MR MATTHEW: I should just say that I agree with Mr Dryden that moving from economic concepts into what the rules should be is a different step and it takes us out of pure economics and now we're into -- let's not use that word -- we're into how do we come up with a test that's practical and works. And I mean, I would say this has been an area, as you will be aware, of intense debate more or less since abuse of dominance by foreclosure was invented as a legal concept. What does it mean and how do we operationalise it?

For me -- and I'm not going to try and answer every aspect but I'll give you my tuppence-worth on how I think a sensible system should work. I think you have some -- it's a category of conduct -- you have some types of conduct that are presumptively, okay, there's nothing wrong with the conduct itself, it's unimpeachable, selling a price if you're a vertically integrated firm supplying others selling a retail price and a wholesale price. There's nothing wrong with those things. And generally we have very strong reasons to think that setting low prices is a good thing and telling dominant firms that they are at risk if they set low prices is a -- almost certainly a bad idea.

Margin squeeze is slightly more nuanced but it's a similar idea in my view, and for those, I think it is right to say that you need a very clear bright line. AEC is a bright line, and perhaps you have some scope for some exceptions, some possibility of rebuttable presumptions in the extreme cases but there you're calling out for a very clear test.

Then you jump to the other end of the scale and say there are some types of practice that are I think close to presumptively objectionable. Mr Holmes used an example in his opening that the idea that for example a dominant firm would simply make a direct payment to potential entrants to stay out of the market I think, you know, it might fall under agreements -- rules on agreements as well, but it seems to me that -- that is abuse of dominance, and the reason is you are curtailing competition without deploying anything that can be called even remotely competition on the merits.

Then in the middle you have really a grey area and we need rules and I understand the need for the rules, and the Article 82 guidance that the Commission produced was one good attempt to try to set out some sort of framework for thinking about some of these things, and I'm not going to answer that general debate. I just -- I can't do that. But what I would say is that I think there is a -- a class of behaviour which is going to have fuzzy edges and is not going to be perfectly defined, in which the idea that you should use the rules that apply for predation and margin squeeze as a pure bright line would not be the right balance of errors, and I think in those areas you do need to move to allow ourselves scope to look at the practice in its context with its effects and say, "Do we think this amounts to anti-competitive foreclosure", and recognise that firms that deploy those types of conduct in those contexts face some uncertainty as to the outcome. I think in those cases the uncertainty is not necessarily a bad thing.

And I'm not going to define the full boundary but I think this case fits all the criteria that you would have in mind. So you have the traditional admittedly sort of form-based approach. So a situation where a dominant firm makes the terms of sale of some monopoly product, an unavoidable trading partner product, contingent on what either a customer or a rival does in a more competitive market. At that point I think alarm bells are starting to ring. It doesn't apply that widely in the economy, it doesn't rule out all forms of conditional discounts, it just raises an alarm bell.

I think those kind of things can be vigorous competition, they can be good. I agree that, you know, if -- conditional discounts might well just be a way of more efficiently setting more aggressive prices implicitly in the competitive market, which we would like to see, and there may be many other efficiency justifications for them, so you have potential for hold-up problems and other things where those kind of arrangements can make a lot of sense.

So certainly it's not saying that those are per se bad, and as an economist I agree that effects should be brought into the equation, but I don't think it's right for me to throw the baby out with the bathwater and jump to saying they're always okay as long as someone passes an AEC test, which I think give you a bright line but one in the wrong place.

My view is I think once you've met certain criteria you have to look at, well, okay, you know, if you pass an AEC, that may give you a presumption to a degree that if other things don't look particularly objectionable, you should be fine. But if other things do look objectionable, so we are clear that it's a penalty, not a form of implicit price cut, it is clear that you're going to get a large -- potentially going to get a large impact on actual competition, you -- you are at risk of being found to have abused your position, and it's fuzzy, but it's to me, you know, not a bad framework in a situation where things are necessarily going to be fuzzy to some degree.

MR FRAZER: So you're saying there is no test and you just have to live with the uncertainty?

MR MATTHEW: In a constrained set of circumstances I think you have to live with the uncertainty, yes.

MR PARKER: I think I would be in a similar place. I think that the more that you can characterise the behaviour as having direct consumer benefits, the more we're in -- the concerns that arise are these excessive competition concerns, and that we need to have sort of a bright line test for when the dominant firm has gone too far but we don't want to chill positive and pro-competitive actions.

The further away from that type of behaviour that we are, I think the more that you need to move -- you move away from the ACT as being particularly helpful and the more that you move into the need for an in-the-round assessment of all of the evidence which could include, for example, looking at the -- how economic theory would tell you that a certain type of pricing structure would tend to have effects and what those effects are likely to be, the extent to which there is the possibility of entrants who are as efficient as the dominant incumbent in reality.

You know, can you envisage a circumstance in which there is an as-efficient entrant or not? What do the facts of the case tell you about the foreclosing effect, if any, on actual firms in the market rather than some hypothetical as-efficient entrant? And so on. So lots of different types of evidence I think you'd want to take into account at that point and I'm not sure there's a bright line test that says: this is fine, this is not.

MR FRAZER: An in the round test I think is what you're saying, is that right?

MR PARKER: Yes.

MR FRAZER: I think I know your views, Mr Dryden, but if you want to come back on either of those, then --

MR DRYDEN: There are three main candidates, as I've said already, for what the objective test can be: the sacrifice test which no one is contending for, the as-efficient-competitor test which I think is the most appropriate one, or a consumer welfare test which in my opinion no one has applied.

What I think has just been described is almost impossible to get to grips with. It has very little structure that I can discern, and that, I think, is deeply problematic. The "in the round" phrase I know has some currency. My view on that is that "in the round" is not the answer to the conceptual question. "In the round", in my opinion, is a description of how one can deal with evidence. So there has to be some coherent concept of what -- or test of what is abusive and not.

"In the round" can be a way of assessing the evidence that goes to the application of that test. "In the round" cannot be a substitute for any notion of a test or any concept of abuse, because then I think it becomes in the eye of the beholder and the exercise can produce any answer.

For example, it was just put that "in the round" takes account of all the evidence. Well, "in the round" as applied by Ofcom does not take account of all the evidence because it doesn't take account of the degree of inefficiency that was permitted by the entrant. So it becomes wholly without structure, and I think that's unsatisfactory.

I think there is -- I think there is an underlying structure to what Ofcom has done that is actually a little more structured than may have just come across and I'm happy at some point now or later to say what I think the underlying structure of what Ofcom has done is, because I think even when at the high watermark of trying to put as much structure on it as I can, I think then it, you know, in my opinion it's unsatisfactory because the elements of the structure that I think is kind of -- is there to a degree, then the structure is problematic and not sufficient.

So either it's kind of without structure, which I think is no good, or it has a degree of structure that I don't think was just explained but I think that -- you know, that degree of structure that may be there is wrong, or insufficient.

THE CHAIRMAN: I don't want to interrupt the free intellectual flow but I think we do want to get to what is being done in this case and I think we want to get there by our own route, if we may. So if you'd like to take us on to that.

PROFESSOR ULPH: I now want to turn to the questions about the rationale for an AEC test in this particular case. So the first question I want to ask is: is this case analogous to a margin squeeze because of the apparent ability of Whistl or some other entrant to cover the cost of service in the event that it rolled out and went beyond a certain level? And would it make any difference to the economic analysis if this case were to be regarded as a margin squeeze rather than discriminatory pricing?

Mr Dryden, do you want to start?

MR DRYDEN: So I think the conduct is a form of margin squeeze, but not for the reason given, if I may say so, in the question.

The question suggests it may be analogous to a margin squeeze because of the ability of Whistl to cover its costs of service in the event that it rolled out beyond a certain level and perhaps that should refer to an AEC. But I think the reason that is given there in the question is the result of the application of the margin squeeze test, so kind of its results can be a reason for it being appropriate, if that makes sense.

The reason, I think, it is a form of margin squeeze is it shares the basic characteristics of a margin squeeze, which is that the viability of the entrant depends on a wholesale price set by the dominant company and by the retail price prevailing in the market, and they're essential features of a margin squeeze because the dominant company has within its wherewithal to exclude an entrant through its control of both of those prices and the fact that it may change one or both of them, which is what's happened here. So it is a form of margin squeeze.

Would it make any difference -- and sorry, I should say I know Mr Matthew has given reasons why he disagrees and I have responded to those reasons, but I will curtail things by not getting into all of that.

Would it make any difference if it was analysed as margin squeeze? Well, not on my approach because if it was recognised as a margin squeeze I think the answer would be applied as as-efficient-competitor test.

For that matter, if it was viewed as a retroactive rebate case or sharing characteristics of a retroactive rebate case because the graph looks the same, the answer would be apply an as-efficient-competitor test. So it would not make a difference to my approach.

However, I should say that I did not adopt an as-efficient-competitor test because I thought this is -- aha, this is a margin squeeze. If one goes right back to the beginning of 2015, my starting point was this is pricing conduct and the alleged harm is exclusion of a rival to Royal Mail in the -- in delivery, and because it was pricing conduct and because it was an exclusion concern, I derived the conditions for whether an as-efficient-competitor could compete or not and checked whether they were satisfied. So it didn't depend on any particular characterisation.

After the event, Ofcom said at some point this is not a form of margin squeeze but I rearranged the algebra and said actually it looks like a margin squeeze. So that explains my approach, which had a rather more general starting point in line I think with the guidance.

It seems to me it would make a very big difference to Ofcom's approach because -- and again, I think we'll need to get into this in more detail -- it's critical for Ofcom to say this isn't a form of margin squeeze, it's critical for them to say this doesn't bear much relation to a retroactive rebate, it's critical for them to say this isn't first degree discrimination and it's critical for them to say this isn't like

Advocate General Wahl's hybrid discrimination, because any of those parallels would take you into the application of an as-efficient-competitor test, to the extent --

THE CHAIRMAN: I think we'll let Mr Matthew make his own case.

MR DRYDEN: Indeed sir, I was about to say to the extent that -- and that's another debate we should have as to whether, if we're in any of those realms, we agree or don't.

THE CHAIRMAN: But you're saying it wouldn't make any difference to your analysis.

MR DRYDEN: The short answer is no difference to my analysis, how it's characterised. My -- if it is appropriate for me to comment on how it would affect -- maybe not -- how it would affect Ofcom's analysis --

THE CHAIRMAN: Well, you can come back on that.

MR DRYDEN: I will.

THE CHAIRMAN: We will allow the others to have their say. Perhaps Mr Matthew as you have been fingered you should answer.

MR MATTHEW: Okay, so I don't think it's a margin squeeze. Of course, it's right to say we are dealing with a situation where there is a wholesale price and there is a retail price at play, but margin squeeze essentially really does no more than say: I have a vertically integrated firm, it's setting a retail price, it's charging its downstream competitors a wholesale price and we want to check whether or not it's squeezing them out.

And that is a form of low pricing analysis because we basically want the dominant firm to be allowed to cut its retail price and its retail margin if it can without excluding, and also they are reasons why you don't want to stop it raising its wholesale price as a matter of general policy because it may just be recovering its investments or any of the other things that go into whether something is an excessive price or not.

What's here is different. I mean, here we don't have a wholesale price and a retail price that may be squeezing, we have two wholesale prices. We have the one that you pay if you stay as an access operator and we have the one that you pay if you start to challenge the core monopoly and enter to take on Royal Mail throughout the value chain. And the essence of the concern in this case is by creating that conditionality you're disincentivising the entrant from taking on the core monopoly and that's not a margin squeeze concern.

THE CHAIRMAN: Just so that I understand that. If we didn't have the issue of the end-to-end entrant having to continue as an access customer for its other purposes, we could then maybe look at it as a case of buying one product at wholesale level and selling it at retail level and we could look at the margin squeeze effects of that, and you're saying it's because of the particular nature of the exclusionary -- alleged exclusionary conduct that the margin squeeze approach is not very helpful? Does that -- I mean, do we agree on that? Our purpose is not to decide which is right, but to try and work out who's saying what.

MR MATTHEW: So, yes, I mean, the essence of the concern here is the conditionality. It creates an incentive arrangement that disincentivises certain types of conduct. If all that had happened is there was one wholesale price in the market and one retail price and you were worried about squeezing out, you would have margin squeeze.

THE CHAIRMAN: Putting it in very simple terms and being very specific for a moment -- I think I'm allowed to do that -- if Whistl moved on to NPP1, they wouldn't be paying a higher price. That's your point, isn't it?

MR MATTHEW: If they moved on to NPP1, sorry?

THE CHAIRMAN: They wouldn't be affected by the pricing change.

MR MATTHEW: Yes, well, I mean, yes. Royal Mail is subject to margin squeeze obligations which stop it margin squeezing NPP1 access operators.

PROFESSOR ULPH: So as another way of stating what you're saying, to say it matters how the margin is squeezed, not the fact that it is a margin squeeze?

MR MATTHEW: Exactly. So you could imagine -- let's forget about access operators etc, let's take a more simple margin squeeze concept where you have a very settled upstream facility and you have a very clear downstream partly competitive retail activity, so there's no -- no issue about disincentivising moving into the core monopoly. And let's suppose the contractual arrangement was not simply you get a wholesale price and a retail price but was rather you get this wholesale price if you limit your sales in the retail activity to 10% of the retail activity but here you get another one if you go above.

Now, at that point you're not thinking about the margin squeeze element, you're thinking about what effect does it have when one of the retail competitors is faced with that conditionality, and you move on to a different sphere of examination and that's where I pick it up.

THE CHAIRMAN: Mr Parker, do you want to respond on this?

Which place are you in?

MR PARKER: I would distinguish this behaviour from a classic vertical margin squeeze. So the standard situation I think is the one that Mr Matthew has just identified, which is you have a wholesale monopolist, for example in broadband access, so fibre network and so on, which is let's say a monopolist, and then you have a retail function selling broadband to customers which is presumptively competitive in the sense that you imagine that there could be plenty of operators at that retail level and they -- and there's no particular advantage for the dominant incumbent upstream in terms of the retail function.

So there's no -- there's no reason to think that it's any better at retailing than anywhere else. I can see that in that sort of margin squeeze context an as-efficient-competitor test could make sense, because you have the possibility of there being an as-efficient-competitor. I think here we're in a different world. We've got that potential retail competition at the sort of access level but now we're thinking of entry at the level at which the incumbent has its dominant position and it has a lot of advantages arising from that dominant position and therefore it seems to me that drawing parallels from the classic margin squeeze cases in case law and the approach that's taken in those is not really that helpful, and personally I would take a wider view of things. But I wouldn't rule out that potentially, if done sensibly, that a price cost test could be part of that but I'm not sure it would be required, or that if you saw some very clear indications from other types of evidence that an observation that an as-efficient-competitor could get in would necessarily be a particularly informative one.

I'm sure we'll come to all these points subsequently.

THE CHAIRMAN: Mr Dryden, do you want to come back?

MR DRYDEN: Yes, so a few reasons I think have been given for why it's not a form of margin squeeze, with which I disagree. The -- Mr Matthew's starting point was to say, well, margin squeeze is a form of low pricing case and this isn't. And again, I've mentioned this earlier on. This kind of fundamental distinction between low pricing cases and not low pricing cases is I think something we will have to come to because I disagree with this simple partitioning.

Professor Vickers in his 2005 article says a margin squeeze can be a raising rivals' costs story. So this bifurcation just doesn't, in my opinion, work.

Then we come to I think the kind of the -- what you could call the geometric arguments which is, well, the classic case is upstream monopoly, downstream potential competitive arena. But the reasons for the application of the as-efficient-competitor test don't depend on the geometric arrangement. We can see that, for example, from the guidelines which, after they deal with the classic case, say actually you can have a margin squeeze through the dominant company raising the price of a complement to the rivals' product. So it need not be even vertical, it could be through the supply of complements. So nothing hinges on geometric differences in terms of the set-up.

Part of Mr Parker's reasoning was he said it was impossible, I think he suggested, to have an as-efficient-competitor in the activity here. I think that's a different debate we may come to.

So I don't think that the reasons that are given for saying this is not a form of margin squeeze are correct. If it's not stretching your patience too much, I might just say one more thing which goes to the Chairman's observation, which is I think what is a distinguishing feature here is the fact that there is discrimination, and I'm always assuming there's discrimination, we've passed that point.

THE CHAIRMAN: So I've got something right, have I?

MR DRYDEN: Everything so far, sir.

So this goes to a counter-factual point. In a plain vanilla margin squeeze case, the test is the as-efficient-competitor test. In this case, because there is discrimination, it kind of creates a possibility -- a new possibility for how to analyse the case, which is rather than checking that the as-efficient-competitor test is satisfied, you can say, well, let's imagine a world where we constrain the dominant company not to discriminate, ie to set a uniform price between the AOs and the DDOs.

Now, the only extra entry that that uniformity constraint can bring is inefficient entry relative to the as-efficient-competitor test, because by definition the as-efficient-competitor test will always give a sufficient entry. But it may be that by imposing a constraint on Royal Mail in this case to set a uniform price between the AOs and the people who are its downstream competitor, that that could bring about some extra entry which by definition has to be inefficient.

But then the question is whether -- well, (a) that is an inappropriate constraint to apply, and (b) whether it leads to higher welfare or not, and my point is you can't assume that inefficient entry will lead to higher welfare.

PROFESSOR ULPH: Are you proposing almost like two tests that you do? You first of all run a test on the assumption that they're constrained to set the same price, and then you run a second test alive with the differentials that --

MR DRYDEN: Sorry, I missed the second test.

PROFESSOR ULPH: Are you proposing there should be sort of two runs of the test? You run it on the assumption that you're constrained to set the same price and then you run it on the assumption that you have a differential, and you check the effect of the differential against the case where you're constrained? Is that your ...

MR DRYDEN: That's not -- that's part -- that's not quite what I'm saying but let me just reframe it slightly. You know, I'm saying that the appropriate way to analyse it, for all the reasons I've given, is using the as-efficient-competitor test and that is a check of whether the -- an as-efficient-competitor can profitably compete or not given the arrangements of pricing. And passing that, in my opinion, would be sufficient for the conduct not to be deemed abusive in economic terms.

There is an alternative approach which would be I think within the rubric of a consumer welfare comparison, where you would say let's imagine that Royal Mail had been constrained to set a uniform price, then it would be necessary to describe that counter-factual and say what price would it have set. Because obviously there's two ways you can get to uniformity. One is you reduce the high price, one is you increase the low price. So if it was increasing the low price, no further forward.

So the first step would be under the uniform pricing scenario to describe the counter-factual which hadn't been done. The second step would be then to compare the consumer welfare level under the factual and that counter-factual recognising that there are -- there is a weighing exercise to do for the reasons that I gave earlier, and that has not been done.

So that's what the implementation of the Salop consumer welfare approach would look like, and it's -- it's -- you know, so I can understand it as an alternative. I don't think it's appropriate for various reasons that I've given and I also don't think it's been done.

PROFESSOR ULPH: Mr Matthew do you want to come back on that?

MR MATTHEW: Just to observe shortly that I agree this is a discrimination case where you're using additional pricing practice but it's not the margin squeeze. So Mr Dryden is right to say that when you're starting to

impose uniform pricing you need to be careful and think hard about what you're doing. But margin squeeze cases aren't helpful in resolving that balancing approach.
So ...

MR PARKER: Any additional points I'd make at this point I'm sure you'll come back to, so I'll happily allow you to move on.

PROFESSOR ULPH: Could I just come back to a point that Mr Dryden raised, which is although we have been talking about this case is a case of having a differential, you would have a differential in many different ways. You would have a differential by putting a price up, putting another price down, or some combination of the two. So if the issue is about a differential, do we need to think more systematically about how precisely that differential was implemented?

MR MATTHEW: Well, I think, yes, you need to think about the differential and you have to think about the nature of the differential, so in particular, you know, does it seem to have put prices up, was it a penalty or was it actually a form of cutting price? And you have to think about the conditionality and you have to go through all those things. So I agree, I mean, but I think for me that's what the Ofcom decision does, and the main response has been, well, but you haven't shown it fails an AEC test, which I think is just a sideshow for that question.

PROFESSOR ULPH: Mr Dryden, do you want to ...

MR DRYDEN: Well, I don't think that's the main response because I think my reports -- my first report, the CAT stage particularly is a report in two parts. The first is applying and considering the merits of the as-efficient-competitor test, the second is considering whether, on the alternative approach of the consumer welfare comparison with the counter-factual, what the pros and cons of that approach are and also whether it has actually been implemented and therefore done.

So my answer to the consumer welfare approach of Ofcom etc isn't to say sort of with my hands over my ears, "I'm not listening, you've just got to do an as-efficient-competitor", it's to look at the pros and cons of that particular approach, as I say, whether it's been done.

I think the starting point for this question from Professor Ulph was on this consumer welfare approach is it necessary to look carefully at the counter-factual? That was the starting point of this, because we can get to uniformity in different ways. And it is my opinion that in this case there has been no meaningful counter-factual analysis which is necessary under the consumer welfare approach. And I've set out in my second report to the CAT a little section on the counter-factual where I say the decision has effectively no meaningful counter-factual analysis, Mr Matthew's report in my opinion has none either, and -- essentially none, and that insofar as there are some kind of fleeting references to the counter-factual they're inconsistent between the two.

So I think none of these questions about if you hadn't set those prices what counter-factual legitimate prices would you have set have really been engaged in any meaningful way, and if that's not been done you can never get to the consumer welfare comparison.

THE CHAIRMAN: So you see the counter-factual analysis as sitting within the consumer welfare test as you put it?

MR DRYDEN: Yes.

THE CHAIRMAN: So it's not relevant to the AEC side of the argument?

MR DRYDEN: That's correct, sir. The as-efficient-competitor test tests a property of the factual. So it takes the factual as we find it and it says: given the factual matrix of the factual, was the as-efficient-competitor test passed or not? So in this case it's just a question of asking, you know, you understand the CCNs and the matrix of prices there would an AEC have been able to compete or not. That's what an ACT involves.

The consumer welfare, rule of reason, Salop etc alternative approach requires a counter-factual analysis in the way that I've described.

THE CHAIRMAN: And when Ofcom say they've looked at things in the round, you're saying that's not analysis, that's just looking at things in the round?

MR DRYDEN: Essentially yes. I mean, that applies to the counter-factual but it applies beyond the counter-factual.

THE CHAIRMAN: I think you suggested it's a way of assessing economic evidence against other evidence.

MR DRYDEN: I'm sorry, sir?

THE CHAIRMAN: It's a way of assessing economic evidence against other evidence.

MR DRYDEN: I was trying to make a slightly different point, which is -- sorry, I think I agree. So it seems to me if one knows what the question is, and in the round -- one can think of an in the round exercise as a way of looking at disparate bits of evidence that goes to the question and deciding what the answer to the question is, but it isn't a substitute for the -- you know, the question.

MR MATTHEW: Just comment on --

THE CHAIRMAN: Do you need to comment?

MR MATTHEW: I don't need to but it was just to pick up on a couple of points, but I can come back. Essentially my points were going to be that I think what Mr Dryden is suggesting here is that Ofcom's in the round assessment isn't sufficient to reach a view that this was actually likely to have a serious impact on competition and consumers.

THE CHAIRMAN: I think he's putting it stronger than that. I think he's saying it's not a recognised form of economic analysis. That's what I understood him to say.

MR MATTHEW: So I think analysing the competitive effects of a course of conduct is a recognised form of economic analysis. And I just observe to the extent it was suggested that Ofcom has not done a full assessment of all the relevant circumstances, including the impact on consumer welfare, the main substantive contributions have been the familiar arguments that competition in bulk mail tends to undermine cost recovery for the universal service products and that Ofcom obviously has looked at that in a variety of circumstances. There's not much beyond that in the reports from Mr Dryden.

THE CHAIRMAN: I think we might move on.

PROFESSOR ULPH: Move on?

We considered before the question of whether entry by a less efficient competitor might improve consumer welfare and the circumstances under which that might be true. One sort of circumstances we talked about was situations which were close to monopoly. We thought there might be a case where entry by a less efficient competitor might be improving consumer welfare.

So in your views are these circumstances met in this particular case, that entry by a less efficient competitor might improve consumer welfare? Are the circumstances of this case fitting to those?

Mr Dryden, do you want to answer that?

MR DRYDEN: I think the answer is that we don't know that they are and there's reasons to doubt that they are. So it's not the same thing as saying definitely not, but we don't know, it's not been demonstrated, and I think there's reasons to be doubtful.

And the reason takes us back to the early stages of the last session where I explained that the increasing total -- let me start again. Where I explained that inefficient entry by definition increases total industry costs before any dynamic efficiencies, and that in general one cannot presume that that will be more than compensated by allocative efficiency, and in this -- it's not been demonstrated in this case that the allocative efficiency would outweigh.

There are references in the -- Ofcom's various reviews that were going on around -- around the time the conduct was formulated it seemed to me that indicate Ofcom recognised the point that it's a balancing exercise and may or may not -- inefficient entry may or may not be good for consumer welfare, and I think a kind of reading of those reviews that said it's clear it can only go one way is incorrect.

Then I would also make the point that for those who say that they're confident that consumer welfare would have been higher within efficient entry, I mean, it seems to me that that is a difficult proposition to make without any limit to the degree of inefficiency, okay?

So there's slightly inefficient entry, progressively more inefficient entry, and then hugely inefficient entry. So the proposition can't be put generally because it matters how much are we increasing total industry costs, because that will go to the -- to whether -- to the likelihood that -- of the weighing exercise, you know, and in my first report to the CAT I presented the degree of inefficient entry that was actually permitted under the pricing conduct, which was reasonably high.

But I just -- I mean, I just want to make the point that it seems to me difficult to have an answer to that.

If one's answer to that question is consumer welfare would definitely be higher, it seems to me difficult to have that as a general proposition irrespective of the degree of the inefficiency. So therefore one would need to look at the degree of inefficiency and yet that was something that wasn't done.

PROFESSOR ULPH: Okay, Mr Parker?

MR PARKER: I mean, it seems to me that there's a fair amount of evidence that goes to this question. So we know that Whistl did come in and we know that it offered price discounts to its customers below the prices of Royal Mail. There's evidence in the decision on that, I think it's 7% to non-CDA customers and 19% on average to CDA customers, so that's a price benefit. I think we know now that the entrant has exited and it's no longer there, and I think the view is that there's no prospect of future entry, that there was likely to be really one shot at this.

In terms of the point that Mr Dryden makes about a potential offsetting consumer benefit, if you like, that excluding entry might mean that total industry costs are lower and therefore that there's if you like no need to raise prices on other elements of the basket, that seems to me to go to the question of whether there's a risk to the USO and that's something that

Ofcom looked at on many occasions.

In relation to the issue of whether there's any bound on the level of inefficiency, well, I think what we've discussed is that as long as your costs as an entrant are below the monopoly price, you will be able to come in, undercut the monopolist's price and still exceed your costs and that gives rise to consumer welfare. Clearly if you are so inefficient that you can't even beat the monopoly price, then you won't -- you can't come in. So that -- there is a bound there and it's a bound that relates directly to the consumer welfare benefits of entry.

And I suppose the final question is one about where the burden of proof really lies, which is -- which is not for me, but I would -- Mr Dryden makes great play of -- Mr Dryden comments that in his view Ofcom has not -- has not done the balancing exercise. But equally, I think Mr Dryden's reports don't do a balancing exercise in the other direction to say, "And these are the sort of circumstances in which one would expect that the static cost benefits of excluding entry exceed the pro-competitive and dynamic efficiency benefits of having the entrant there", and that is not a question for me, but that's merely an observation.

PROFESSOR ULPH: Mr Matthew?

MR MATTHEW: I think Mr Parker's put it well. For me, in this case, entry -- this was the only chance of entry. It would have had a substantial competitive effect and we've heard evidence around that.

I think, on the argument that entry needs to be proven -- sorry, that competition needs to be proven to deliver consumer benefits, which is essentially one way of reading what Mr Dryden is saying, that seems to me the reverse of what I would expect. Competition presumptively delivers consumer benefits, and if you want to argue that it won't, you should have a pretty strong reason for saying: normally competition is good, but not in this case.

And there is an issue here around the USO. It's an issue that Ofcom did look at precisely with the dynamic that Mr Dryden discusses in mind.

THE CHAIRMAN: Can I just ask by way of follow up, they were talking about the circumstances being present in this case. I mean, it may be a silly question, but can I just ask each of you, is Whistl an efficient competitor, an as-efficient-competitor, or a less efficient competitor for the purposes of your approach to this case? Mr Dryden?

MR DRYDEN: Given that the as-efficient-competitor test was -- well, it's slightly difficult, because the CCNs weren't implemented.

THE CHAIRMAN: I'm just asking for your sort of overall approach, because it does colour the way you discuss it I think.

MR DRYDEN: The beauty, in some ways, of the as-efficient-competitor test is one doesn't take any view about the efficiency level of the entrant. The whole idea of the as-efficient-competitor test is it sets the right threshold against -- and I say "right", you know, that comes for a number of reasons, but on the view that the as-efficient-competitor test is a good test, the idea is that it sets a threshold, and it will attract desirable entry and it will not create headroom for other entries. So -- it doesn't require taking a view.

THE CHAIRMAN: I understand that --

MR DRYDEN: -- so it doesn't require taking a view.

THE CHAIRMAN: -- but you must have in your mind the idea as to whether you think Whistl would have passed or failed whatever test you would have imposed on it had you been in charge of the case.

MR DRYDEN: Right, indeed, sir. So setting aside kind of wrinkles for non-implementation, etc, if we were simply in -- if we're in a world where the as-efficient-competitor test has been passed and yet the entrant has chosen not to enter, or has exited, then that reveals that the entrant is not an as-efficient-competitor.

Shall I have another go at that?

THE CHAIRMAN: Not entirely. Mystified at an entirely higher level now.

MR DRYDEN: I think I'm just saying that if the as-efficient-competitor -- if we're in a market where the as-efficient-competitor test is satisfied and that means that an as-efficient-competitor could profitably enter and therefore we assume it would choose to enter, if we then observe an actual entrant whose efficiency level we do not know chooses not to enter, we infer that it is not an as-efficient-competitor; it must be less efficient.

THE CHAIRMAN: If it chose to enter, then you would infer that it was efficient -- as efficient?

MR DRYDEN: If the test is just satisfied, then it's as efficient; if the test is satisfied with a degree of headroom, then it's --

THE CHAIRMAN: The same discussion as we had before.

MR DRYDEN: -- as before.

THE CHAIRMAN: Okay.

Mr Parker, how do you categorise your company that has instructed you?

MR PARKER: So perhaps if we start from what we might define an as-efficient-competitor to be.

THE CHAIRMAN: I suppose that's where we get to. I was trying to short-circuit that.

MR PARKER: Well, with apologies, let me unpack that. I think the definition of an as-efficient-competitor is one that has the same unit costs as Royal Mail, or as the incumbent if we're talking more generally, and it seems to me that in this case Whistl will be less efficient because it will operate on -- at least initially -- on a lower -- you know, lower national scale, it will have lower volumes, or not benefit from the same sort of economies of density that Royal Mail might benefit from, and that it has to meet the LRIC of Royal Mail because, in the nature of the test, the common costs of setting up that delivery network and delivering in a particular area are allocated to the USO or other parts of Royal Mail's business in the formulation that Mr Dryden's described.

THE CHAIRMAN: Well, that seems to mean, as we can't envisage an entrant which would exactly replicate Royal Mail's scope and scale, that every potential entrant will be less efficient; is that right?

MR PARKER: I think in this particular context that's right. I don't think there is a realistic as-efficient entrant on the basis I've just described. Now, it doesn't have to be exactly identical to Royal Mail, but it does have to have the same cost errors. You could achieve those in different ways, potentially.

I would distinguish this case from the situation of -- if we go back to the classic vertical margin squeeze case where we're talking about the dominant firm in the wholesale market, which is non-replicable, but we have its retail arm which is contestable, replicable, no obvious reason why, say, BT's retail business has a particular advantage over Sky's retail business, over some other broadband retail provider's retail business.

THE CHAIRMAN: Just by way of illustration.

MR PARKER: Purely by way of illustration. But in that world, it makes sense to think about an as-efficient-competitor test, potentially, because you can imagine that there are in reality as-efficient-competitors out there, because there's no particular advantage to the incumbent in the retail business, the advantages to the incumbent are in a different bit of its business which is not facing entry.

MR FRAZER: But isn't that the case here, in the retail and where you've got intense competition for the customer upstream, but retail, and no competition, or less competition or less scope for it, downstream, which you would regard as wholesale in this case. I know it's all ...

MR PARKER: So I would say -- at the level of the access operator, so retail, I would say yes, you can get as-efficient-competitors there, and we've seen that competitors have come in and competition is thriving and surviving, because it appears that Royal Mail that is no insuperable advantages to the retail end of the business, so the upstream. Whereas here we're talking about entry into the wholesale part of the business, so the delivery element, and that's where I think you can't realistically expect an as-efficient-competitor at that level of the business, which is the level of the business where Royal Mail has its dominant position and where it has various advantages and in principle disadvantages as well, which I'm sure we'll come to, but I feel we're in a world of net advantages for Royal Mail.

THE CHAIRMAN: Mr Matthew, your chance.

MR MATTHEW: Okay, so I agree with -- I mean, the factual character -- or the empirical characterisation is we have the incumbent who has a network in place, on Mr Dryden's analysis, that it then can use to sell bulk mail at the margin on, and then we have an entrant that concentrates on bulk mail alone, the entrant has some cost advantages, potentially quite significant ones, that plays against Royal Mail's advantages, which is it's got a network and it has some of the other advantages that, you know, incumbent firms often have, such as the customer contracts, the reputation, etc. Who's more efficient? You know, one could evaluate. I don't know, I haven't worked it all out.

I would say, just on the concept, though, I mean, if you were going to go down Mr Dryden's route and say, "We're going to treat this as the as-efficient-competitor", it does raise a question about whether we imagine that this as-efficient-competitor is supplying all of the services, and I think Mr Dryden's presumption that they are. Well, my understanding is that he has in mind an as-efficient-competitor is one that will come in and potentially take over the USO services as well.

THE CHAIRMAN: So all of the services at the same level of service.

MR MATTHEW: Yes. Now, in practice that is not going to happen in this market, so if that's the as-efficient-competitor, in reality it won't exist. But i think it does raise a question I haven't examined in detail and don't touch on in my report as to whether, if you've got a multi-product firm, how do you apply the as-efficient-competitor test to the real as-efficient-competitor? And what I think you would probably need to do is check that it's covering its costs across all services, not merely in bulk mail, and you would need to give thought to whether treating pricing down to marginal costs for bulk mail is actually enough to cover the costs of the entire network. I don't know if Mr Dryden has done that analysis, but it seems to me a conceptual point to address.

Mr Harman's report -- sorry, not Mr Harman, Mr Parker's report does take steps by using, you know, a fairly arbitrary allocation of some of the common costs, which is one way of getting at that issue, but I think those sorts of issues do arise if we want to go through the hoops of saying, well, it really was an as-efficient-competitor who supplies all the services.

THE CHAIRMAN: Just on my simple naive question, you're assuming that a new entrant in Whistl's position is likely to be less efficient?

MR MATTHEW: If it's faced with -- we assume that the -- Royal Mail has access to the USO network at zero contribution to common costs --

THE CHAIRMAN: Given the facts we have.

MR MATTHEW: -- it probably would be, yes, I would think so.

THE CHAIRMAN: Probably.

Mr Dryden, you're looking at worried.

MR DRYDEN: I'm deeply worried, sir. The original question was whether each of us thought Whistl was as-efficient-competitor or not.

THE CHAIRMAN: Yes, and I accept that it's a very untutored question.

MR DRYDEN: And it was -- but I think, in the answers, that it has kind of morphed into a question of what "as-efficient" means. So let me be very clear what "as-efficient" --

THE CHAIRMAN: I can assure you, we will be coming to that.

MR DRYDEN: So if it's helpful shall I make some responsive remarks?

PROFESSOR ULPH: Well, I want to cover that in quite some depth.

THE CHAIRMAN: Yes, you do. I think maybe -- again, you've put down a marker and we will cover it in more depth, if that's acceptable.

I'm sorry for trespassing on your --

PROFESSOR ULPH: Well, that was exactly the question I was going to come to next, so should we take a break now?

THE CHAIRMAN: I think we should go on for another 10 minutes.

PROFESSOR ULPH: What?

THE CHAIRMAN: Another 10 minutes, I think.

PROFESSOR ULPH: Okay.

MR FRAZER: In that case, if we're just going on, can I just come back to something you said, Mr Parker. Are you saying that in the circumstances the postal delivery market is different from all other network markets, because what was concerned here was not necessarily competition, as it were, on the local loop but across the entire supply chain and we should look at it differently from the dynamics of competition in other network industries? Am I reading too much into your answer?

MR PARKER: So I think the relevant situation for me would be -- or the analogous situation in, say, a telecoms world would be an entrant comes in to provide some infrastructure in competition with the infrastructure incumbent, but the customers want access to, say, a national network and therefore they have to buy from -- if they could buy full access to the national network from the incumbent, or they could buy access to the national network from the infrastructure entrant, who will have entered in on a small scale in, you know, certain areas, for example, but to sell then a national product, a national service to its customers, it will have to come to some arrangement with the incumbent infrastructure provider as to what do you do in the remainder of the country where you're not present.

And that -- so it's -- it's the relevance, or the analogy, is competition at the place at which the dominant firm has its dominant position as opposed to competition at the retail level where this infrastructure is present, say there's a dominant monopoly provider of that, that monopoly provider has a downstream -- sorry, a retail arm in which it has no particular advantage in -- arising from its dominant position, it's just one of many potential retailers. So I would say in that circumstances where the entry is taking place at the level -- the retail level in which the dominant firm has a presence but doesn't have any particular advantages, then I think you can sensibly conceive of as-efficient-competitors entering.

Where you're thinking about entry into the situation where the dominant firm has its advantages, then I think it's very hard to think of a world in which you have as-efficient entry.

MR FRAZER: That's clear, thank you.

THE CHAIRMAN: I think I'm persuaded, we'll break now and come back promptly at 2 o'clock.

(12.55 pm)

(The short adjournment)

(2.00 pm)

THE CHAIRMAN: Right, where were we, Professor Ulph?

PROFESSOR ULPH: The next set of questions I want to explore with you essentially covers material we were talking about just before the lunch break. It's all about the question of what do you actually mean by an "as-efficient-competitor", and can you actually have literally an as-efficient-competitor in this context.

So I'm going to break this down into a series of questions. The first question is about on what scale would an as-efficient-competitor operate. Do we conceive of an as-efficient-competitor as operating at the national level in every single SSC, or can we conceive of an as-efficient-competitor at an SSC by SSC level? So which of those two approaches, are both of those approaches okay or which of those should we prefer? Mr Dryden, do you want to start?

MR DRYDEN: Yes. So I think it's quite important to distinguish how we construct the test from how we think the entrant might look, and I think there's a risk of confusion if we don't distinguish those two.

As far as the test goes, the standard approach in cases such as this is to think of the as-efficient-competitor as being defined by the increment of the conduct in question. So in this case the conduct in question covers bulk email, so the increment is being given by bulk mail, and then we look at the dominant company's costs for supplying the increment in question, so that's Royal Mail's LRIC for the bulk mail increment. And that's the starting point for thinking about what is the as-efficient-competitor test.

There is then a question which also goes to the construction of the test, which is do we just calculate that test and check the satisfaction of that test over the entirety of the increment, the whole of bulk mail at a national level, or do we also calculate the test and check the satisfaction of the test at intermediate points, which are basically the SSCs which describe a roll-out path.

And I've done the latter. It is by construction more conservative because you are checking not only can an entrant that came in big bang full scale compete, but you're checking that an as-efficient-competitor at every level of roll-out could profitably compete. And I also believe that's a standard approach and I can elaborate if necessary.

That is the construction of the test. What the entrant actually looks like we are completely agnostic about, and I also -- it's not really within my expertise to know. So the commercial entry strategy, whether an entrant is or isn't as efficient and etc, is kind of beyond my knowledge.

PROFESSOR ULPH: Okay. Mr Parker?

MR PARKER: So for me, I would agree with Mr Dryden that the bulk mail increment is if the entrant is entering into bulk mail I think you should look at that increment. I would generally reiterate my view that at that point you need to have the same unit costs as the -- as the incumbent, and to me you need to look at the whole of bulk mail, ie you need to look on a national scale, because otherwise, if you only look at the entrant in certain areas, you're essentially saying, "I don't have the same unit costs as the incumbent in the areas that I'm not serving. I either have much higher unit costs -- some unknown but really high level of unit costs which means I can't serve, or I rely on Royal Mail for access and then I've got higher unit costs because the access price is well above the LRIC".

So it seems to me -- and I think Mr Dryden's quite clear several times in his first report and then also reiterates in his fourth report that the true as-efficient-competitor is the UK-wide competitor. It seems to me once you start then -- if that's the case, of course we're in a slightly strange world, because --

and I would agree that's what "as-efficient" means -- we're in a strange world because at that point the entrant does not rely on Royal Mail for access, because it's as efficient, it has the same unit costs everywhere, so it doesn't need to rely a third party to fill a gap, if you like. That third party has no advantage that can be filled.

So I think once we start talking about an entrant who is only present in certain areas, we are by definition talking about some kind of less efficient entrant than the incumbent, and then it's -- we're in a different world of in what way should we take account of differences between the as-efficient entrant and a sort of realistic entrant.

PROFESSOR ULPH: Mr Matthew?

MR MATTHEW: So I think I'd just make one -- one observation. So if we go to Mr Dryden's increments, so he's done the test on the basis of entrants can test some subset of the UK and then required the entrant to pay the wholesale prices that it incurs elsewhere. I just wanted to make one comment on that, that it seems to me that if you're testing it in that way, so we have an entrant that's planning to enter London, for example, you should test it as if it's an entrant who's -- an as-efficient entrant who's contesting London, and that is a potentially significant point here, because the base case in the actual test that we'll come on to essentially calibrates the geographic areas, the profile of roll-out that is assumed in the test is that which Royal Mail's own costs would say is the most appropriate one. So it's not directing the test at the areas where the entrant is actually focusing on potentially.

PROFESSOR ULPH: Mr Dryden?

MR DRYDEN: You know, I disagree with several things that have been said about my approach. The approach that I've adopted on applying the as-efficient-competitor test, it doesn't just look at the national scale, it looks at all intermediate points of roll-out. If I was just doing the national scale I would have drawn that graph and I wouldn't have had two lines, I would just have had two dots at the right-hand edge where it's 100% roll-out and I would have checked that the as-efficient-competitor test were satisfied at that level. So I have looked at all the intermediate points.

When I'm looking at degrees of roll-out, I'm not looking at a less efficient competitor than Royal Mail, I'm looking at the -- you know, I'm looking at an as-efficient-competitor of Royal Mail but for partial roll-out rather than for complete roll-out, and what I'm doing is analogous with the way that retroactive rebates get analysed.

So in a retroactive rebate case, the application of the as-efficient-competitor test proceeds by recognising that the dominant company has got some non-contestable units and there are some contestable units. And what you check is not that the test is passed across all units of the dominant company, but you check that it's passed across the contestable units. And that is quite closely parallel to the way that I'm doing it here, because if you view different degrees of roll-out as different degrees of what you view as contestable SSCs with all the other SSCs being uncontestable, at least in the short term, what I'm doing is applying the as-efficient-competitor test in the precisely analogous way that it would be applied in a retroactive rebate case.

So the fact that I'm departing from this --

THE CHAIRMAN: When it's done there it's done contemporaneously, there's no time sequence.

MR DRYDEN: That's right, sir.

THE CHAIRMAN: Does it make no difference, you think?

MR DRYDEN: Conceptually I don't think it makes a difference, because in those cases you're not saying, as Mr Parker I think did, that -- I think if you applied Mr Parker's argument to the retroactive rebate case, when you do it over the contestable units he would be saying this is not an as-efficient-competitor test any more, and you've opened Pandora's box and we should start not only looking at different scale but we should change the cost function etc, that's not what's happening in the retroactive rebate case. You just check it's satisfied over the contestable years.

Now here there's a time dimension as to how you think of contestable units but it's not, in my opinion -- you know, it's not very different.

THE CHAIRMAN: The only difference I can think of is that the success of one roll-out may affect the conditions for the next roll-out so the sequence is a relevant factor.

MR DRYDEN: Sequence and success of each level are no doubt relevant factors but we've checked -- we have determined in the base case the sequence, one on an as-efficient-competitor basis, and we have checked that the test is satisfied at an every level of roll-out. So an as-efficient-competitor could choose to stop at any level of roll-out and be profitable.

MR FRAZER: Mr Parker, I thought I heard you say that an entrant at a scale smaller than the full scale of Royal Mail would be by definition not as efficient because it's at a smaller scale. So if you're looking at an SSC level where an entrant is present in some SSCs but not all, it would by definition not be as efficient. When you're looking at an SSC, how is that affected by if you were looking within the SSC it may well be that the entrant has lower costs than the incumbent for all sorts of reasons. Would you still regard the entrant to be less efficient notwithstanding it has lower costs serving that SSC or that under the SSCs?

MR PARKER: Well I would say in that case it is efficient within that specific SSC, but in all the SSCs that it's not operating it is less efficient because it cannot -- it does not have the same costs as Royal Mail in those SSCs, and it's the existence of those SSCs in which the entrant is not present that gives Royal Mail its advantage.

So Mr Dryden mentioned that he was saying: I've done an as-efficient-competitor test where the entrant was efficient, I think he used the words "but for" that it doesn't have a national presence. But the term "but for" indicates, I think, that we're looking at something that does not have the some unit costs as Royal Mail in all the relevant areas.

So I completely understand why this analysis only becomes interesting once you start building in an asymmetry between the incumbent and the entrant, but to me, that by definition means that the entrant is not as efficient, it is less efficient in some way.

THE CHAIRMAN: Are you in agreement with Mr Dryden on his distinction between constructing the test and identifying the potential entrant, and that what we're talking about is ways of constructing a test and we can be agnostic about the characteristics of an entrant? Are you with him on that, or do you disagree?

MR PARKER: I'm not sure I completely followed the argument that Mr Dryden was making --

THE CHAIRMAN: I probably haven't expressed it very clearly, but did I get the gist of it?

MR DRYDEN: I thought it was a good summary, sir, yes.

THE CHAIRMAN: Thank you.

MR PARKER: It would seem to me that when you construct the test you need to define your as-efficient-competitor, and perhaps I might go back to the situation of vertical margin squeeze, which is our standard world, and we have a dominant incumbent wholesale provider of some access -- some infrastructure product, and then we have retail operations, and that's a world where the entrant, because the dominant firm has no advantages, can essentially come in and fully replicate the dominant firm's offering. And if it makes sense to think of that as as-efficient, to do an as-efficient-competitor test, because as-efficiency is possible, you can have something that has the same unit costs in all dimensions as the incumbent, doesn't need to be a total clone because it could be more efficient in some ways, less efficient in others, but you can at least conceive of an as-efficient entrant there.

It seems to me here if we're talking about a test in which an entrant comes in into a handful of areas, by definition that entrant is less efficient than Royal Mail because it must have higher unit costs elsewhere.

As I say, Mr Dryden is very clear that for example normally an EEO test is conducted not just on the cost of the dominant company but also at the scale in which it operates. On that basis it would be appropriate to consider the test set out above on Royal Mail's level of roll-out, ie UK-wide. Then he says because that's not very interesting, I then look at the sequence of roll-out plans at different levels of roll-out.

But it seems to me once we've taken the view to move away from something that has the same unit cost as Royal Mail to something that is on a different basis, then I think we're in a REO world, a reasonably efficient operator, we're in an acceptance that the entrant must look different to the incumbent, and that -- then I think we need a set of principles as to how we define what REO is.

THE CHAIRMAN: But we're still constructing a test.

MR PARKER: This is still in construction -- well, it's in constructing the test and in defining what this potential entrant of either as-efficient basis or reasonably efficient basis is. To me that's I think in defining terms.

THE CHAIRMAN: I suppose what I'm asking is whether you agree that the sharp distinction between the exercise of constructing the test and whether you are agnostic about what the entrant looks like -- which were your words -- I mean, do you accept that as a way of thinking about this? Because you seem to be talking about characteristics of the entrant while you're discussing what sort of test you would construct.

MR PARKER: Well, I think the hypothetical as-efficient entrant should have the same unit costs as Royal Mail everywhere, and that -- that's my version, I'm abstracting from any real world entrant, that's my version of constructing the test and I say in that world that hypothetical as-efficient entrant would never need to be reliant on Royal Mail and it would never have to purchase access, and all of the strategy that we have in -- we have in mind here is therefore -- will never come into play.

PROFESSOR ULPH: I have three questions that follow from this. Is this partly just semantics as to what you actually call an as-efficient-competitor? Mr Dryden, were you in court earlier this week when Dr Jenkins was giving her evidence?

MR DRYDEN: I was.

PROFESSOR ULPH: Because she talked about an as-efficient USO competitor and was quite clear that she meant a competitor that was in every single SSC in the country. That was her notion of an as-efficient-competitor, which I think is what Mr Parker is talking about as being that would be the conception of an as-efficient-competitor. Whereas Mr Parker would now say that if you're only looking at an as-efficient-competitor that's in some of the SSCs in the country, by definition that would not be an as-efficient-competitor in that sense we've just defined. Is that summarising the ...

MR DRYDEN: So I can't recall that particular part of Dr Jenkins' evidence, but Dr Jenkins did apply an as-efficient-competitor test herself.

PROFESSOR ULPH: That's true.

MR DRYDEN: And at that stage -- for that purpose her notion of an as-efficient-competitor was as efficient in the supply of the bulk mail increment for which the relevant cost measure is Royal Mail's LRIC for the bulk mail increment and has nothing to do actually with Royal Mail's cost of supplying other services. I mean, it's conditional on them, but it's not the same thing.

When we ... on the issue of semantics, the idea of an as-efficient-competitor test is that it creates conditions where over some relevant increment someone who's more productively efficient than the incumbent will have a profit opportunity to come in, and someone who is less efficient for the supply of that increment isn't guaranteed a profit from coming in, and that has nice efficiency properties and administrability properties and etc.

The application of the as-efficient-competitor test to bring about those kind of effects has to be done with proper application to the case at hand, and in this case it seems to me that it would be very aggressive to say you only apply that test at full roll-out. So what I do is I check that the test is satisfied at every level of roll-out. In so doing, I am departing from a sort of clone view of the entrant but I'm not departing from as-efficient-competitor principles and the motivation for the test, because what I'm doing is the test is creating conditions where an entrant who is as efficient as Royal Mail for a few SSCs or five or 10 or 15 or 20, all the way along that path, that is as efficient for the supply of those volumes will be able to profitably enter and someone who's less efficient isn't guaranteed to be able to do so.

So when I do the roll-out path I'm maintaining the sort of motivation of the as-efficient-competitor test and that's why I don't say when I'm looking at partial roll-out, well, now that I'm at partial roll-out I'm going to also assume that -- start thinking about the entrant and think well they might have very high costs because they're only doing one SSC. That just doesn't enter it because I'm thinking about the test.

PROFESSOR ULPH: Okay, but my second question then would be that if you're thinking about the sequence of SSCs in which you're going to be examining the entry by the as-efficient-competitor, do you do that on the basis of the sequence of SSCs which would be most profitable where Royal Mail's costs were being used, or do you perhaps think about looking at the sequence that was actually used by in this case Whistl? So which of those approaches would you take?

MR DRYDEN: So my preference is for the former, because I think it also follows in a slightly different way but it also follows as-efficient-competitor principles, and that's the way we've ranked the order in the base case.

I think when you move away from that, it's -- you hit the problem that you always hit when you move away from the as-efficient-competitor test and try to proxy the actual position of the entrant, which is the incumbent doesn't know for sure. So the alternative you gave me was that it should reflect the actual entry sequence of Whistl, but I mean Royal Mail is not going to know that. In general an incumbent isn't going to know that.

What we did do -- what Mr Harman did was a sensitivity to the base case which assumed a different roll-out sequence. That wasn't the actual roll-out sequence of Whistl, I think. Royal Mail can't know it. It was a different sequence.

PROFESSOR ULPH: Okay.

Mr Parker?

MR PARKER: I mean, I think if we're talking about the as-efficient-competitor, that's UK-wide scale, so it's 100%, so I think the question of the sequence of the roll-out does not arise. If we're talking about some reasonably efficient competitor that does not operate at the full national scale but operates in some very restricted area and then is reliant on Royal Mail for access elsewhere, I mean, it seems to me strange to say that that hypothetical entrant we're looking at should choose to enter in the areas where Royal Mail has the lowest costs, because those are going to be the ones which are most challenging for the entrant to operate in. So any realistic entrant is going to have its own -- his own roll-out profile, but this to me is all variants on reasonably efficient operator, not as-efficient.

PROFESSOR ULPH: That's very clear.

Mr Matthew?

MR MATTHEW: I think it's the same point I raised a few minutes ago. I mean, if the entrant is planning to target London, you should apply the test, if you're going to use it, to London; and if you've applied it instead to Nottingham, that's not -- doesn't seem to be informative.

THE CHAIRMAN: But I think this is the distinction Mr Dryden drew between constructing the test and examining a potential entrant. I'm still slightly struggling with this, I have to say, as a non-expert, because they actually seem to be looking at much the same thing in the sense that you're essentially adjusting your test to take account of the fact that an entrant will actually enter on a much more limited scale, because that is -- as you said, that's where it gets interesting, that's where you have to look. And because you're constructing a test which has its own sort of intellectual dynamic, you have to stick with Royal Mail's characteristics, because as you say, you can't know.

I won't mention, just forensically, that of course whether Royal Mail could have or should have got access to Whistl's roll-out plans is another point that need not bother you, but it's a matter in dispute. It could have got that information, but not for your purposes, obviously.

Then really Mr Parker's coming along, and Mr Matthew also, saying that you can't be agnostic about the realistic entry in a case like this if your test is to be any use, otherwise you're in pure theory and you're not actually looking at the market as it is, market behaviour as it's likely to be, and one can always criticise a test that produces a perfectly theoretical answer which doesn't actually work when related to the market. Are you with me? I don't mean do you agree, I mean do you understand what I'm saying?

MR DRYDEN: Yes, so I think there are two different issues. One is, as you go to smaller degrees of roll-out, less than complete, do you depart from using Royal Mail's costs.

THE CHAIRMAN: Can I just stop you there. We are all agreed, are we not, that the only realistic entry in this market situation is at less than full scale, yes?

MR DRYDEN: I'm proceeding on that. That may well be the correct basis.

THE CHAIRMAN: Yes? Well, I thought it was more than "may well be a correct basis".

MR DRYDEN: I may be getting too agnostic.

THE CHAIRMAN: There are limits to agnosticism. The world is round, the sun is up there.

MR DRYDEN: I've looked at every level of roll-out --

THE CHAIRMAN: I understand why you would start with a sort of total clone approach, but if you've already accepted that that's not -- never going to work, it's never going to give us the answer we need, you have to construct something else. And then we're arguing about whether that construction should be a subset of the original national level or whether it should take account of the possible characteristics of a realistic entrant.

MR DRYDEN: Yes, and I'm with you, sir, on all of that. So --

THE CHAIRMAN: Now I'm worried.

MR DRYDEN: And when we get to the -- so we are certainly concerned with roll-out below the full national scale.

THE CHAIRMAN: But it's a notional entrant's roll-out, it's not Whistl's roll-out.

MR DRYDEN: That's right. So everything I've done from the beginning is always looked at every level of roll-out and I'm perfectly happy to accept that the most probable roll-out might have been more on the left-hand side of my graph than the right-hand side.

THE CHAIRMAN: This is coming back to the argument that if the AEC test is to be a useful tool in deciding disputes and planning by dominant companies as to what they can do, they have to have the costs information within their own --

MR DRYDEN: Right.

THE CHAIRMAN: -- sphere of knowledge, they can't just speculate on somebody else's costs.

MR DRYDEN: So I think the premise, which I think we're all agreed on, is we are concerned about -- maybe even more than concerned, we might even be focused on roll-out that is less than national scale. So that's the premise.

That gives rise to two kind of implementation questions. One is, do we say that it goes together with that that we also have to depart from Royal Mail's costs? And I think that proposition is being put and I disagree with it. So the fact that we're being --

THE CHAIRMAN: I think we understand your disagreement.

MR DRYDEN: The other proposition is what sequence shall we use because as soon as you're looking at less than complete roll-out, the sequence matters, which I was trying to say from the beginning.

THE CHAIRMAN: You could perfectly well look at Royal Mail's costs in London, for example, if that's where Whistl's going to start.

MR DRYDEN: And that's what we do. So I have conditioned in the base case the sequence also on AEC principles being on Royal Mail's costs, and that means that the -- you know, we're sticking to using Royal Mail's costs and we have a sequence that is determined by Royal Mail's costs and that gives us the result of the AECT at every level.

The sensitivity differs in one way, which is it changes the sequence, but it doesn't, apart from one wrinkle, change the costs, so you're still using Royal Mail's LRIC.

THE CHAIRMAN: Mr Parker?

MR PARKER: I mean, it seems to me once we've departed from replicating Royal Mail's costs, wherever Royal Mail is operating, then we're moving to a world where the entrant is not as efficient as Royal Mail, and then comes the question what principle should guide how we think about the position of the entrant. It seems to me I have a principle, which I've set out, which is we should control for the net advantages, or the advantages and disadvantages of the dominant firm arising from its dominant position, to think about how we move away from an AEC to a situation of a realistic entrant, a reasonably efficient competitor, essentially reasonably efficient over the activities that it could reasonably contest, which is -- of which one dimension is we are not expecting full national roll-out.

But I think once you -- I don't think you can say the only dimension that I'm going to change is the dimension of roll-out without thinking about everything else that might fall into that wider principle of the net advantages of the dominant firm arising from its dominant position.

So I don't think it's a matter of just saying well, in this way I'll make a difference from the as-efficient-competitor test but only in a very specific way. I think you're then in a different -- a different architecture, a REO architecture.

THE CHAIRMAN: Reasonably efficient is not the same as having a realistic roll-out plan. They're different. I know they both begin with R, but they are actually both different concepts.

MR PARKER: So I think a --

THE CHAIRMAN: You're rather using them interchangeably.

MR PARKER: That's fair. So a reasonably efficient operator I would say is one that is as efficient as Royal Mail subject to the non-replicable bits of Royal Mail's offering, so controlling for those bits that arise from its dominant position. That will give rise to potentially a different set of costs that are relevant, and that could also give rise to a different sequence of roll-out that would be optimal for that reasonably efficient operator.

PROFESSOR ULPH: You're also perhaps using the term REO to mean realistically efficient operator, so you're trying to capture what might be the realistic attributes of any potential entrant that might come in to the market. Is that a way of thinking about what you're saying, or is that not?

MR PARKER: To the extent -- I think to some extent, and the way that comes together, I think, is if you strip out the advantages and disadvantages of the dominant firm that accrue as a result of its dominant position, everything else is something that a realistically efficient entrant should be able to replicate on its own basis, because it's not -- there's no inherent inability of it to compete, it should be able to do that. If it can't do that then I think it's, you know, not as efficient as the reasonably efficient operator.

So if the realistic entrant for whatever managerial inefficiency reason can't even get to that standard then I would say that's -- you know, that's -- if that's a realistic entrant, well maybe it's still not reasonably efficient, it's somewhat less than reasonably efficient.

PROFESSOR ULPH: Realistic but inefficient.

Mr Dryden, do you want to -- I think we understand yours positions now quite well, but do you want to come back, Mr Dryden?

MR DRYDEN: Yes, I -- you understand my position so I'm not going to repeat it. So one observation I would make is if we agree that if roll-out were hypothetically -- which it isn't -- at national scale, could be at national scale, we agreed that in that scenario we would apply the as-efficient-competitor test. What seems to be being said is the less the actual roll-out is, the more we must assume that the entrant is relatively inefficient, and therefore the more headroom we have to provide to allow it to come in.

So it becomes -- you know, the dynamics of how this works become rather kind of curious and counterintuitive in my opinion. I think we should do as we do in a retroactive rebate case when the contestable volumes are less than the total volumes and all the same arguments could be made, we should do what we do there, which is we stick to the dominant company's costs and call it an as-efficient-competitor test applied over the contestable volumes.

PROFESSOR ULPH: Chairman, are you happy for us to move on?

THE CHAIRMAN: Well, I was wondering, if you two had to decide this case, what questions would you ask each other to try to convince the other of the correctness of your views?

Mr Dryden, how would you persuade Mr Parker that your approach is right and his is wrong? I know you're trying to do it through us, but ...

MR DRYDEN: Well, I mean, I think we've tried to do it through our reports and through the joint statements and I'm not sure I can say much more than I've already said and what I've said there.

THE CHAIRMAN: There's no silver bullet.

Mr Parker?

MR PARKER: I think I'm in the same place but perhaps at the other end of the spectrum.

THE CHAIRMAN: I won't say which is the wide end of the telescope and which is the narrow, but take that away.

Mr Matthew, you're reigning above the fray on this.

MR MATTHEW: Yes, it's not an area I've concentrated on. For me, if they're entering in London you should apply the test as if they're entering in London. The argument that the dominant firm doesn't know where they're going to enter is -- and therefore as a matter of certainty it should be looking at where it itself would enter I think is not hugely convincing, because in this case actually Royal Mail had worked out a model, I understand, of where it would be more profitable for the entrants to go in.

And secondly, in these sort of circumstances, if you're not sure you can check, and there's nothing stopping you setting up your spreadsheet to check it for perhaps the more likely areas where the entrant may be coming in and convincing yourself that you had passed the test on all of them.

THE CHAIRMAN: If you did conduct this analysis, say in London, would you look at the actual entrant's cost structure or would you look at Royal Mail's cost structure to try and work out where the efficiency bar should be?

MR MATTHEW: So in a world where I agreed where we should be doing a test of some kind --

THE CHAIRMAN: Yes, I prefaced it by that.

MR MATTHEW: Sorry, I'm going to open up new themes that we haven't been talking about, but I think in this sort of circumstance where you have a single one-off entrant and the cost structure of the incumbent is the marginal cost of a non-replicable USO network, you would be looking very, very closely at whether there should be at least a contribution to the common cost, so if you're going to adopt an AEC approach of some kind. And I think you would look very closely at, in any event, given the difficulties of taking Royal Mail's network and costs and trying to use them to draw any kind of inferences at all as to what the position of the entrant would be, in my view you should be adopting some form of check that even if your version of the AEC test that you've done would be passed, that within reason REO would also pass in likelihood.

MR FRAZER: So that means you are looking at the dominant undertakings cost in order to determine whether the entrant is being unfairly treated; is that right?

MR MATTHEW: No, I think it is -- it is a way and it's the way a dominant firm would itself obviously have to conduct any such test, because it only knows its own costs. My point was simply that in this case, and taking into account the broader circumstances, this might be one of the very exceptional cases where you accepted, well, even though the dominant firm's own costs might be passed, I do need to look further because it's a one-off entrant into a market that's otherwise a monopoly, and with the discussion we've already had about the nature of the conduct and whether we should be using this sort of test in the first place, those things become relevant. And so I think there is a case here for saying there should be some kind of recognition that if you think you would be driving out your only rival, you should be taking that into account.

MR FRAZER: So if you think you're driving out your only rival, you should be taking account of the relationship between price and cost and informing yourself about the likely difference between your costs and the entrant's costs. But it's still a price cost test, is it?

MR MATTHEW: My view is you shouldn't be using a price cost test in this case, but if you were going to do one you certainly should do that, and what you shouldn't be doing is setting up your practice having worked out what you think is necessary to make the rival not enter.

MR FRAZER: Right, and where would you do that? Just coming back to one of your earlier answers, you say if they're going to enter in London do it in London.

MR MATTHEW: Yes.

MR FRAZER: But also you quite rightly indicated -- observed that you don't know where they're going to launch, so you would have to do that perhaps on a series of different launch possibilities, would you? How would you work that out?

MR MATTHEW: If I was advising, I would -- yes, I would say, "Look, you know, you are exposed here, you're doing something that you've calibrated to -- let's leave that aside -- you're undertaking a practice that may make it very substantially harder for the only rival to come in, okay you don't know exactly where they'll be, but you can have a punt at where it will be, and if you're not sure you can do sensitivity assessments, and you probably in this sort of environment should pass the normal by a good margin".

MR FRAZER: Understood. I'm still not quite with you when you say you should carry out these tests, but still this particular case is one where a price cost test wasn't necessary. How would you proceed without a price cost test if you were trying to understand whether your conduct was likely to exclude in these circumstances?

MR MATTHEW: Okay, so if -- so we're looking at the effects of the conduct here. So we're not using a price cost test in the way that Mr Dryden would like to use it, so it becomes the bright line filter. If you're looking at the effects of the conduct, I think -- let's take it in two stages. There's the evidence of the overall case so we have some idea of what the effects of the conduct were here. We had one entrant, it was Whistl, they are the only -- whether they're an AEC or an REO, let's call them an REO, they're the only one and they were able to find a profitable entry here faced with the conduct.

You then step back and say, "Okay, but what did the dominant firm know"? Well, I agree it's not always easy for a dominant firm to work out what effect its conduct might have on a rival, but it's my view that when the dominant firm has calibrated its conduct in order to achieve that effect, you can say, "Well, you should have been reasonably aware that your conduct might have the effect of excluding this only rival".

MR FRAZER: So is this back to the fuzzy middle and the area of uncertainty that you mentioned earlier this morning?

MR MATTHEW: As I said, I think, yes. So if you're in the sphere -- the fairly restricted sphere where these sort of practices in this sort of market context with the broader evidence is available but you still want to do some version of a price cost test, my view is you don't need to, I think you would do that test very much with the filter of that broader context in front of you, and that would probably make this one of the exceptional cases where simply showing that the dominant firm can cover its marginal costs in the areas it itself would find most profitable to mention is not -- not what you should -- is not adequate.

MR FRAZER: Thanks.

THE CHAIRMAN: I think we can move on.

PROFESSOR ULPH: So we're going to come to another issue which has surfaced a little bit in the discussion. So the second issue is how should account be taken of Royal Mail's enjoying a VAT exemption by virtue of its USO obligation? At first sight that VAT advantage seems like an externally conferred benefit on one firm in an industry, in this case the dominant firm, since by definition there will only be ever one designated USO. So how should we take account of that in constructing the test?

Mr Parker, do you want to start in this case?

MR PARKER: Yes, sure. Well, I think if we look at a pure as-efficient entrant, then it should be assumed to have the same VAT advantage as Royal Mail, because that's as efficient. You'll give it the same cost. Or it has somehow to be 16.6% more efficient than Royal Mail for the relevant customers through some other means. It still has to have the same cost. So that's what the as-efficient-competitor should be. I don't think it's realistic or reasonable to expect any real world entrant to be able to replicate that, so I think in the spirit of the principle of how we define a reasonably efficient operator, or at least as I have set it out, this is a non-replicable advantage of Royal Mail that results from its dominant position and therefore we should not require the reasonably efficient operator to have to match that advantage.

PROFESSOR ULPH: Okay.

Mr Dryden?

MR DRYDEN: So there are -- I think it's not appropriate to adjust for three reasons essentially. The first is that -- well, the first -- I can make the first the one that Mr Parker mentioned already, which is if we think of efficiency as a post-tax position of the firms, then the entrant has to match the post-tax efficiency level of the incumbent. So if it's as efficient in pre-tax terms but then it has tax added, and if we add headroom to allow that to happen, we will increase total costs borne by customers that have to be recovered through prices.

So there are -- the same efficiency reasons that has guided everything else would also mean that we don't adjust for VAT. That clearly creates an advantage for the dominant company, but it also maintains the efficiency properties of the test.

The second reason is I think -- the second reason is that assuming that the VAT is pursuing some policy objective, then unwinding that advantage through the application of the test may undermine the policy objective. That may stray a little bit into the trading off of competition policy against other policies and etc which may be more a matter for the CAT than for me.

THE CHAIRMAN: Do we have to go there?

MR DRYDEN: I'm sorry?

THE CHAIRMAN: Do we have to go there?

MR DRYDEN: Not if you accept the first argument, sir. But if you don't, I mean, it seems to me there is an issue there. And we can think of it in another situation, which is imagine that Ofcom triggered a universal service fund and Royal Mail was somehow getting some credit for doing universal service and then we were applying the price cost test in that context. If the application of the test involved unwinding the benefit of being a beneficiary of the fund to the advantage of entrants, then effectively the fund could never work because it always gets unwound in the application of the price cost test.

So I think there's a genuine issue when the VAT or other advantage emanates from some purpose that one can't trivially say, "Well, it should just be reversed", without taking into account you may be reversing the objective that it had, and that's really the point.

PROFESSOR ULPH: Could you say in this case that because there are certain costs involved for Royal Mail in meeting its USO obligations, VAT exemption is to some extent a partial way of offsetting it? So it's like having an externality. So this tax, somehow this tax advantage is correcting an externality that's out there, it is not by itself distortionary, and so you can allow competition principles to apply. That would be one way of thinking about a justification for ignoring the VAT which appears a somewhat different line from the one you were taking which is just on a purist as-efficient-competitor test, we just assume this is given to the entrant as well.

But then the question comes down to do we have to check then that the VAT exemption does indeed compensate for all those costs, and does that take us back to the proposal from Mr Parker that we have to model much more explicitly the VAT exemption, all the costs to the universal service obligation, six days a week delivery etc and just model all those explicitly and then try to see what the net effect of all those is? Would that be your position?

MR DRYDEN: Well, so my position is the following, and I'll give a very brief restatement just to avoid confusion.

So the first reason for not making a VAT adjustment is on the grounds of pure efficiency.

The second reason for not making an adjustment would be that the VAT is pursuing some other policy objective and therefore one can't at least do it lightly without taking into account that one would through the application of the test be potentially unwinding that.

I think I would make what you said, sir, a special case of that, which is when it's -- which takes it a step further, which is not only to say it's pursuing a policy and it's in compensation for some burdens, but you go a step further and you're actually going to weigh the costs and the burdens and then do the net adjustment. So I don't think you need to get there but that would be a logical extension -- sorry, that would be an extension of that argument.

The third reason why I think a VAT adjustment is slightly difficult is that only a relatively modest proportion of customers are affected. Now, if we -- imagine we make an adjustment that is equal to the sort of average benefit of Royal Mail across all the customers, that adjustment is going to be -- and we do it with the objective of compensating the entrant for the disadvantage. If we do the average adjustment across all customers, that adjustment is going to be too small -- considerably too small to help the entrant for the CDA customers because it's been diluted, but it's going to allow for inefficient entry and an advantage for a less efficient entrant across all of the other customers.

If, on the other hand, we give the full VAT advantage to the entrant across 100% of bulk mail volumes, then they'd be in a kind of neutral position as far as the CDA customers go, but they would then have an advantage over everything else, and it arises because the tax is not hypothecated. Or maybe put it differently, it arises because there aren't two different prices. If there was a price for the CDA customers and a different price for the non-CDA customers, you could have two price cost tests and adjust one for VAT and not adjust the other if one went down that route. As long as there is only one set of prices, the adjustment is not trivial, because either it's too small or too big.

THE CHAIRMAN: Mr Parker.

MR PARKER: In response to some of these points, in relation to the efficiency argument this might make sense in a world where what we care about is static cost efficiency, I'm not sure it made sense in a world where what we care about is consumer welfare and the ability of an entrant to come in and compete.

We actually saw I think that Whistl was coming in and offering very large discounts, more than the VAT advantage to encourage its non-CDA customers to switch, and that's obviously benefits to those customers.

In terms of whether it's a payment for the USO and for the obligations of the USO, I mean, it's clearly -- it's clearly related to the USO, but I'm not sure that for the purposes of the test, the ACT, or similar test, that it's that sensible to take it into account, because if we think about an entrant into bulk mail, what the test as I think Mr Harman has carried it out does is say, well, all of the costs of the USO and serving the USO and all the common costs of setting up a delivery network to do six days a week, and so on, are essentially outside the scope of the test and the only costs that are relevant for that bit of the test are the incremental costs of additional bulk mail services, not anything to do with the USO, so -- but -- and the VAT benefit clearly applies to those USO costs.

But it also applies when you're competing in bulk mail but you've already had -- but there's a big advantage to Royal Mail in competing in bulk mail because of having the USO services and having common costs that can be applied entirely to the USO services for the purposes of this test.

So I wouldn't agree I think that it would be sensible to omit it from consideration as an insuperable advantage that Royal Mail has that should not be controlled for. And then I think in relation to CDA and non-CDA customers which do or don't benefit from the VAT exemption, I think it's sensible to look at both, as Mr Dryden and Mr Harman have done, and to split out the two approaches, if you're going to go down this route of a price cost test focusing on a sort of static cost-efficiency benchmark.

PROFESSOR ULPH: Just to be clear, I wasn't suggesting that the USO only conferred costs to Royal Mail, I do agree with you there are also benefits through the common costs, economies of scope argument.

Mr Matthew, do you want to --

MR MATTHEW: I don't have any particular observations other than the VAT point.

THE CHAIRMAN: Just a silly point of clarity, talking about consumer welfare. That is derived through the benefits to the customers of the bulk mail services that we're talking about, is that right? The person who wishes post to be delivered, it's not you and me?

MR PARKER: No, it's the bulk mail -- the purchaser of bulk mail services.

THE CHAIRMAN: Helpful to have that in mind I always think when considering these things.

PROFESSOR ULPH: Okay, so the next point I want to raise basically is just a follow-on from the last point we were talking about, because apart from the VAT advantage, Royal Mail potentially enjoys other advantages by virtue of its USO obligations, so economies of scope between its bulk mail delivery and its USO obligations. On the other hand it does operate under certain constraints from the USO, having to deliver six days a week and deliver to all parts of the country.

So the question then is, should we handle this by effectively the route that Mr Parker was suggesting, you know, a realistically efficient operator or a relatively efficient operator and we just put into the framework all these costs and benefits to the incumbent of being a USO operator and then simply model the net effect of all of that in deciding our test? Rather than trying to decide whether the VAT advantage compensates, just throw the whole lot in to the modelling and see what the answer is. Is that a suggestion that you -- because at one point I think you say something about let's try to net all this out and see what happens.

MR DRYDEN: So I mean, I recognise that that would be the logical consequence of a certain track we were going down but which is not the same thing as saying I think it would be a desirable end point.

Sir, I think the exercise that you describe is a tremendously complex one.

PROFESSOR ULPH: I don't deny that.

MR DRYDEN: Yes. And I can't see how it can -- I can't really see how it can be part of an ex-post type of regime. I can see how it could be part of an ex ante regime, where if there's an objective to introduce some competition but a concern to do that balancing all of the costs and benefits in etc, that this kind of way of thinking could inform an ex ante regime that could give a degree of entrant support and allow in a somewhat inefficient entrant, and critically I think describe a glide path for how that entrant support evolves over time as the entrant actually comes in, because at some point presumably the level of support changes or is withdrawn and etc and that matters a lot for the dominant company, it matters a lot for the entrant and its investment decisions. So I can't readily see how it fits ex-post, from a practical point of view.

If I may say also there's a conceptual point. I've dealt with one conceptual issue which is the glide path issue. There's another conceptual point which is it's still not clear to me conceptually what those realistic entrant or reasonably efficient operator or whatever it's going to be called, conceptually what it is. I think Mr Parker at one point in his report talks about an entrant that doesn't share the density benefits of the Royal Mail.

Now, it's easy to postulate that. So we can, you know, imagine -- we can imagine that we take -- we can imagine a symmetric duopoly, for example, where we have the Royal Mail with its fixed costs and half the mail volumes, and half the mail volumes come across to an entrant, and in that way we've obviously dealt with all the advantages and disadvantages because now it's symmetric. We've fulfilled the objective of reducing the density of the Royal Mail, but it's impossible to believe that with very high fixed costs and falling mail volumes and etc that that market structure could really work.

So then -- and I've sort of dealt with this in my reports -- if you're not going to go the whole hog, how far is one going to go? If one goes beyond covering the incremental costs and start to put in some degree of common costs and we're not going to go the whole hog, how far are we going to go in terms of allowing headroom for some degree of cost duplication to allow Royal Mail to lose density and the entrant to gain it? And what I don't see is a conceptual stopping -- a conceptual guide to where we stop in that exercise. The end point seems to me to be almost ridiculous.

Then the problem is, if we're not going to go to the end point, where do we stop on the -- on that path, and I can't see a clear definition of the stopping point. And that brings us back to the as-efficient-competitor test.

MR PARKER: I'm not sure I would agree with the conclusion that because something can be done, it is the thing that one should do. It seems to me, in a world where we can't conceive of a realistic as-efficient entrant that looks like Royal Mail, we are conceptually at least in a world where we need to think about a reasonably efficient entrant if we want to try and get the benefits of competition in the form of price competition and dynamic efficiency and we're not just focusing on static efficiency.

So I think for me conceptually it's quite clear. The REO is the as-efficient incumbent but controlling for its advantages and disadvantages that arise from its dominant position. So as a matter of concept, that feels to me clear, at least in my mind.

I totally accept that as a matter of practicality it's extremely difficult to do, and I think there's two possible ways -- maybe three ways -- to deal with that.

One way is to say I don't think it's sensible in this context where we can't conceive of an as-efficient entrant to try to do a price cost test. Because trying to do anything sensible is not possible and there we should look to other evidence rather than trying to remain in the price cost framework but in a circumstance that doesn't really -- doesn't really make sense because it's not realistic. I think that's one way of doing it.

Another way of doing it is the sort of sensitivity approach that I set out in my first report, what I called a SLEO, a slightly less efficient operator, where what I was doing is saying I don't know what the full set of the net advantages of Royal Mail was, but let's suppose that I add to the costs of the purely as-efficient entrant as subject to not being UK-wide scale but otherwise as set out by Mr Dryden and Mr Harman. Let's add certain amounts to that and see what happens to the ranges of foreclosure for those entrants which are somewhat less efficient, and use that as a way of seeing, does that give us an illustrative idea as to how damaging certain types of conduct are.

And what I found was that you don't have to add very large amounts, given the difference between LRIC and FAC, before you get very wide ranges of foreclosure.

So that would be like a sensitivity-type analysis, a sort of variant of the approach Mr Matthew was saying was we should look at things in different ways and think about how far away, you know, do we start seeing foreclosure in different scenarios.

So I think one world is not to do the test at all and one world is to think about how we can adjust it to take account of these factors even if, and my third world is you properly go and get all the evidence and you try and work out what the answers are, and I accept that I suspect is probably impossible, but that's I think why the SLEO approach, if we are in this world of we must do a price cost test, which I'm not sure necessarily seems to be right, but if that's the case, that's why I think that gives us some insight without losing, you know, too much in terms of complexity.

PROFESSOR ULPH: I fully accept your point about trying to get precision about the magnitude of all these things you might want to put in and do the test carefully is an extremely demanding thing to do. So the idea of at least checking out how sensitive are your conclusions to at least going partly down the road towards doing that may just help you to understand the extent to which your conclusions are likely to be moderated by taking these factors into account. So that seemed to be the essence of your motive, am I right?

MR PARKER: Yes, that's right.

PROFESSOR ULPH: Mr Dryden, how would you --

MR DRYDEN: I have a conceptual difficulty because it's predicated on -- or it seems to me to come close quite often to all being predicated on the notion that if the approach doesn't lead to some actual entry, then something is wrong with the test. So any test which doesn't result in a degree of actual entry hasn't been a good test because it hasn't dealt with a realistic entrant.

So I mean in that world we just know, or would know that a dominant company is engaged in abuse of conduct if its conduct hasn't actually led to competition and it should just create more and more headroom for an inefficient entrant until the entry happens and I, you know, don't accept that because what's being proposed here is, I think, essentially that. We don't know, as we add in Mr Parker's 1p, 2p, 3p, which is effectively a duplication of costs, increasing total industry costs.

We know at some point it will attract entry, but we don't know that at the point at which it attracts entry consumer welfare will be higher than with the conduct, because, going back to where we began today, you know, as you add 1p, 2p, 3p in etc, that upward pricing pressure from productive inefficiencies and the scope for allocative efficiency I think is essentially fixed.

So it seems to me an approach that's predicated on a sort of "there must be entry" type of idea that is lurking there to some degree, which I don't accept. I think in an ex-post context the AECT has a number of variants that leads to its adoption in many cases.

If we're dissatisfied as a matter of outcome that there isn't actually entry, that can be a problem that can be addressed through ex ante measures that can tackle these more complicated trade-offs and consider whether a degree of entrant -- inefficient entrant support may be merited and described to the whole industry, all participants, a regime -- policy regime in which that will be provided and potentially in the future withdrawn. So I -- I think that is getting inappropriately shoehorned into an ex post framework.

THE CHAIRMAN: We need to stop, I think, but are you actually saying that Ofcom should have conducted this analysis once the prices were announced without any regard at all for the actual entrant, Whistl? They should have simply looked at Royal Mail's cost information and just asked themselves the question: is this conduct liable to foreclose anti-competitively shutting their eye totally to the facts? Is that what you're saying? Perhaps I've put it slightly extremely.

MR DRYDEN: Slightly.
THE CHAIRMAN: Being agnostic as to the effect.
MR DRYDEN: No, what I'm saying is in an ex-post context --
THE CHAIRMAN: Which is what we're in.
MR DRYDEN: Yes, I think my preferred approach for Ofcom would have been that it would have applied an as-efficient-competitor test which is heavily fact contingent rather than independent of the facts. It depends --
THE CHAIRMAN: But Royal Mail facts.
MR DRYDEN: Indeed. It depends -- well, Royal Mail facts as far as costs go and then also as far as prices go, but the prices are of fundamental importance here. So I believe it should have applied the as-efficient-competitor test. I think the as-efficient-competitor test is passed and that should therefore have led to a conclusion that there wasn't an ex-post case.
In the alternative, if Ofcom had gone down a more consumer welfare/Salop structured rule of reason type of approach, then I think I disagree with that, I think the as-efficient-competitor test is preferable, but I think if you go down that route there are lots of elements of the analysis which are missing. So they could have embarked on that but they would have had to have done

things they didn't do.
THE CHAIRMAN: You've made that point. But if they were doing that analysis they would be allowed to look at the nature and characteristics of the actual and potential entrants.
MR DRYDEN: That -- that analysis does -- could potentially bring in some of those facts, yes.
THE CHAIRMAN: But on the first part of your answer, they really don't have to look at whether there is an actual entrant and what the nature of its entry is?
MR DRYDEN: I think that is essentially correct, except -- I mean, except, sorry, for one caveat which we've already dealt with, which is we are looking at sub-national entry. So we're taking into account that realistic entry would be below national scale.
THE CHAIRMAN: But that's still a theoretical concept because you're working down from your full national operation.
MR DRYDEN: That is also done on AEC principles, yes.
THE CHAIRMAN: That is a good moment to pause for 10 minutes, if we may, please.
(3.15 pm)
(A short break)
(3.27 pm)
THE CHAIRMAN: On we go.

PROFESSOR ULPH: I'd just like to start with a follow-up question to the discussion we've just been having.

Supposing we go down this route of a relatively efficient operator type of test, so we put in all these factors which may advantage or disadvantage the incumbent by virtue of a USO and we try to understand the effects of that on potential entry with the price differential, does that imply we ought to now do two tests, because how do you distinguish what might be a limiting entry by virtue of all of these other factors that we're throwing into the analysis from the role -- or the potential role that the price differential has?

So do we need to first of all put all these factors in, understand how far that would have allowed entry by a potential entrant, and then secondly add in the price differential or what other type of behaviour that has been conducted here, and then ask the question: now we know the role of these factors, has this price differential created a lack of entry that otherwise would have been there but for the differential? So are you now committed to doing this kind of counter-factual analysis if we want to go down this route of an REO? I just want to understand what your positions are.

Mr Parker, maybe if we start with you.

MR PARKER: So I think the way I would think about it is we essentially have two lines on a chart, we have a sort of target line, this is the efficiency of the as-efficient-competitor, and then there is the in practice what cost would the entrant have to have over its proposed level of roll-out to be able to survive and is one below the other. So I think about, if we start from the AEC, as Mr Dryden and Mr Harman have calculated it, what I think we are really talking about from the perspective of a REO type analysis, if that's the route one was going down, would be moving that line presumably up, sometimes down, in terms of any net disadvantages that you think Royal Mail incurs, but otherwise up to control for the non-replicable advantages that it contains -- it benefits from as a result of its dominant position. So that raises that target line, if you like. And then you don't actually need to change the other line at all because that's the line that looks at the effect of the price differential.

So I think it's a -- it would be a more calibrated version of my SLEO analysis, so a SLEO analysis is if this was how the net advantages came out in LRIC terms, say 1p, 2p, 3p, what would then happen to the areas of foreclosure? You don't need to change the other line, the kind of implication of the access pricing and the price differential, you don't need to change that line at all. So if one was going to go down this route, and as I say, I'm not sure that's necessarily a sensible thing to do, but if you were going to do a price cost test, this would be, I think, the way to adjust what we have already.

PROFESSOR ULPH: But the problem I have is that that upper line you're describing is constructed on the basis that there is a price differential, if I've understood it correctly.

MR PARKER: Yes.

PROFESSOR ULPH: So the extent to which that -- or where that cuts with these other lines that you've got on the -- the lower lines, may depend on the shape of that upper line. So I am just saying in principle, to understand separately the effects of the price differential, should not one maybe construct the top line first of all without the differential and then with the differential and then just see what does that do to your zones at which entry might be forestalled?

MR PARKER: So I think --

PROFESSOR ULPH: Or you think it just doesn't make a difference in your analysis?

MR PARKER: Well, I think where you end up is the situation with all of the elements of the CCNs in it as a whole. So I guess what you could do is say let's take out the effect of the price differential and have some further line and then have an additional higher line and then have a look at what happens as a result of the price differential. I think that, I suspect, would not be a particularly challenging addition to the calculations to do.

PROFESSOR ULPH: I'm just saying should we in principle -- if we're going to go down this route, should that in principle be the thing that one does, just to check that we've understood properly the effects of the price differential?

MR PARKER: Yes, I think that would be a way of identifying the impact of the price differential away from other types, other aspects of the conduct and it seems to me it would be a sensible counter-factual to say what's the situation -- here's the impugned conduct, what would the situation be without the impugned conduct and that would be the relevant way of doing the actual versus counter-factual.

PROFESSOR ULPH: Mr Dryden, you're looking quite pained.

MR DRYDEN: Sorry, I was just thinking. So I think there are two separate things going on in this discussion. One is I think a causation question about whether, if there were foreclosure, the differential causes it, and that I think can be analysed through the top line in the graph. So because I find the as-efficient-competitor test to be passed, that is a sort of sufficient condition for me to say there isn't foreclosure in -- anti-competitive foreclosure in economic terms. Had I found the test to be failed, you could have then -- one could then do a causation question and then say is there a different line without the differential, and if that is also failed you would say, well, the differential didn't cause the fail of the test. But then I think you'd just call that a margin squeeze test fail, so I'm not sure whether we'd be any further forward. So one can look at the causation questions through the top line.

The other line, I think I agree with Mr Parker that if one is doing all of these adjustments, they would operate through the other line, but I struggle to see the guiding principle for to what extent one is trying to create headroom for the duplication of costs, ie inefficient entry.

PROFESSOR ULPH: Okay.

MR DRYDEN: Sorry, I shouldn't have said "ie". I mean either the duplication of fixed costs or simply higher variable costs. One or the other.

MR MATTHEW: Forgive me, it was just a quick question of clarification. So is the question that the possibility arises that where the price differential is paid the REO exits, can't compete, but there is a further possibility that even if the price differential hadn't been added to the wholesale price, they might have failed that one too? Is that the --

PROFESSOR ULPH: The point I'm making is just that once you go down this route of adding all these other factors, you have many factors which might drive the conclusion as to whether or not entry has been foreclosed, and if you want to understand the role of the action of the dominant firm in foreclosing it, my suggestion was that you ought to run two scenarios, one without in this case the price differential and one with, just so you fully understand the role that price differential has played. I just wanted to get your reactions as to whether that was in some sense what this whole proposal was pointing towards.

MR PARKER: Can I maybe expand on my answer possibly with reference to some charts?

PROFESSOR ULPH: Okay.

MR PARKER: Can I maybe suggest you have a look at my supplemental report, probably, which is in -- it's in tab 10 of the second bundle for me, but I'm not quite sure what that is.

PROFESSOR ULPH: Is this your report?

MR PARKER: It's my supplementary report with slightly updated results compared to my original reports.

THE CHAIRMAN: One that came in quite recently.

MR PARKER: Yes, with apologies. I'd suggest we look at, if we have that, page 17 and page 18.

THE CHAIRMAN: Just to be clear, these are the charts that would have been in your main report if you had --

MR PARKER: If I'd evaluated on an SSC by SSC basis. They're pretty similar.

THE CHAIRMAN: So we should imagine them as if they were in your original report?

MR PARKER: Yes.

So in this situation, just to give you an indication of the impact of the price differential, and now this goes into the question of the eligibility error which I don't know if is on the agenda for today but no doubt will be on the agenda at some point, but essentially what happens if the end to an entrant gets -- ceases to be eligible at the sixth SSC is it starts incurring a very large chunk of cost and it's that additional chunk of cost that leads to the fall at around about 5.5/6%. So that, if you like, is what's attributable to the price differential.

And you can see that if you didn't have the price differential, then that drop would not happen and then you wouldn't spend so long trying to recover if you like. So that would be an illustration of how one might -- essentially one would sort of fill in that gap because you wouldn't see the sharp increase.

I recognise that there is some dispute about the factual position on the eligibility error, so really I'm offering these in the spirit of showing how these charts might look in a world if you just tried to strip out the fact of the price differential, or identify it.

MR DRYDEN: So, I mean, what can I say about this graph? The orange line is above the dark blue line, so this is a pass of the as-efficient-competitor test. It's still a pass of the as-efficient-competitor if I add a penny, because the negative zone is tiny. It's still a pass of the as-efficient-competitor test if I add 2p, because the negative zone doesn't look like it's deep and wide enough to affect the NPV of an entrant unless it's -- full stop. At 3p, one might begin to think there's a serious question there about whether foreclosure could have happened and want to investigate that further. That's the usual way of interpreting these.

But what we don't know from this is whether, if we accommodate 3p worth of inefficiency, whether consumer welfare is going to be higher or lower, because we don't know whether the increase in total industry costs from the 3p and the productive inefficiency that's associated with that creating upward pricing pressure will be compensated by enough allocative efficiency from the entry to bring the consumers into a position of being better off. And also, if 3p was deemed to be a pass, we don't know -- we have no reason -- we have no objective reason to know why a 4p line wouldn't be added to the graph and that would be a fail. So these are the kind of difficulties one encounters.

As far as the orange line goes, that is determined -- the cliff edge is determined by the differential. As I said earlier on today, the approach to assessing an as-efficient-competitor test is actually a factual analysis so it's not a counter-factual analysis. So it just asks a question about a feature of the factual which is could an as-efficient-competitor compete given the factual prices or not. This graph gives an answer to that. It's not necessary to do a counter-factual. Were one to do a counter-factual of the orange line under uniform prices, that could clearly take different locations on the graph. It could be setting aside, yes, other knock-on effects, which are quite hard, I think, to think through.

The horizontal orange line could lie near the minimum point of the current orange line. The entrant would actually then prefer to have this line than a flatter line. Or it could lie to the top and then of course the entrant would prefer that. But we don't need in general in assessing a price cost test to get into that sort of counter-factual question.

MR PARKER: So I think that would be some of the ways you might look at using this graph, but the other way to look at the price differential of course would be to look at what actually happened to Whistl and how it responded when it heard about the price differential. So that would be the more factual matrix part of it and there is evidence that I quote in my report, but also in the evidence of Mr Wells and Mr Polglass, as to what they did in response to the price differential as a -- you know, alone.

THE CHAIRMAN: So you both agree this is how you would look at that graph, is that right, but you disagree as to the conclusions that would be drawn from it?

MR DRYDEN: I think in large part that's true.

THE CHAIRMAN: Sorry?

MR DRYDEN: Well, I think we agree, sir, in broad terms how to interpret the graph. I think we disagree on the necessity and appropriateness of some of the lines.

THE CHAIRMAN: I just didn't want to be deceived by the measure of agreement that appeared to be breaking out.

MR PARKER: This is subject to the view -- you know, the assumption that a price cost test is a sensible thing to do.

PROFESSOR ULPH: Just two more questions in this section.

THE CHAIRMAN: Carry on.

PROFESSOR ULPH: So I think we've largely covered the first one of them, but let me just pose it to you. So what are the strengths and weaknesses of using economic tools other than an AEC test to conduct an in-the-round assessment of the impact of conduct on competition or consumer welfare in a case like this?

Mr Matthew?

MR MATTHEW: Okay, I think we're reiterating some of the themes from this morning. The strength of an AEC test is commonly held to be the -- it gives the dominant firm certainty and it provides a bright line as to how far you can go. The weakness is that there may be types of practices in certain market contexts where you get what an economist would say is anti-competitive foreclosure even if such a test was met. And the interesting policy question is how do you then design a framework that tries to capture both without chilling, deterring good things, or alternatively being very permissive about bad things.

And that leads you to the strength of the alternative approach in exceptional cases perhaps, or at least in those areas where, you know, we've got a set of conducts or contexts where we can say, well, we've got a lot more worries than we would do for the low pricing categories where we want to use AECTs as a safe harbour. And there the strength is the fact you are able to start capturing some of the real foreclosure cases even where an AECT might be passed.

And the weakness is you have to accept that not everybody knows precisely where they stand on every aspect of their conduct and one tries to put in place presumably sensible rules around that, presumptions, rebuttable presumptions, strengths of evidence, etc.

I would just make one other remark. I mean, we've talked a lot about the design of the AECT in this particular context and I think people have remarked on how difficult it is actually to come up with one that seems to work for all the relevant purposes, and I'm just making an observation, this isn't a generic objection to AECTs but they're not all that easy in practice to implement, and I think especially where you start to bring in considerations of the position of the entrants can they match certain things, and you start to move down REO type rules.

Then I think Mr Dryden makes this point, and I think it's broadly right, generally relying on price cost tests per se as your determinative feature becomes more difficult because the price cost test itself starts to become a bit more uncertain. At that point, for me, you either go back to AECTs and you don't capture some things or you move towards more relying on other evidence as to the impact -- the intention, the nature and the impact of the conduct.

THE CHAIRMAN: This is probably a very unfair question but are you able to be objective about the views you've just expressed given your position within Ofcom? And I don't mean that as a criticism. What I'm just saying is what you've described is a method of analysis which is quite -- it fits quite well with the role of a competition regulator. It gives you an important role in investigation, quite a significant role in analysis and it gives you a certain amount of discretion as to the judgement you come to. If you put yourself into the position of the incumbent, you would accept, wouldn't you, that it does look a little bit different? It looks as if the world is more uncertain.

MR MATTHEW: Yes, and I do appreciate those points. I don't take these views because I am reflecting the views of Ofcom --

THE CHAIRMAN: That's what I'm not suggesting.

MR MATTHEW: Like everybody in this area I've been struggling with how to draw these lines since I started out in 1993. I mean, we had very -- you know, the same issues were arising back then and those were the days when certain types of behaviour seemed to be deemed as per se objectionable even though as an economist you would look at them and say, "Well, hang on a minute, where's the foreclosure here?" You know, "and I can think of potentially benign reasons for this that you haven't really explored". And obviously the dial has rightly moved away.

For me there are exceptional cases and it is right to try and draw lines and to try and get the balances correct and to make those as understandable to everybody. But when you have a case like this -- and I don't think we need to design the frameworks purely around this -- you know, this is a case where if I go through all the checklists of when I'm looking at anti-competitive foreclosure in the classical sense, this one, on the face of the facts, does seem to tick a lot of the boxes and to a very substantially greater extent than you normally would expect in a lot of the dominant abuse decisions that you've seen.

Decisions often don't for example expect the Regulator to have shown, you know, effects, actual effects. In this case we've got actual exit. Often other cases don't require you to show a clear intent, or haven't, or find that difficult to do, and in this case it seems that was present.

And to me there is a place to find these sorts of processes anti-competitive even though it's not fitting with the perfect bright lines, and I think the way to do it -- I mean, if you really are worried about giving regulators too much discretion to do what they feel like, the way you do it is you say well there are general rules and there are rebuttable presumptions and in this case one might say the presumptions are rebutted but there's lots of ways of cutting it.

It could go the other way. You could say when you have this sort of nature of conduct in these sort of market circumstances, the presumptions go the other way and the dominant firm should be on notice that if it wants to use contingent pricing that require potential entrants to do X, Y and Z to get a good monopoly price, they need to show it's a good thing and that's objective justification that sits out there.

THE CHAIRMAN: I suppose in this case Royal Mail would say that was precisely why they put the suspensory wording into their price announcement.

MR MATTHEW: They say that, but that seems to me to be an extension of what the core conduct was. I mean, there we get into --

THE CHAIRMAN: I'm not going there, but I'm just saying they must have been conscious of the uncertainty as well. That may be. You would say not?

MR MATTHEW: Well, my understanding is that they were aware of the potential risks around this set of practices.

THE CHAIRMAN: Your position is that must inevitably be the case in situations like this. There must be risks and incumbents must see that there are risks and act cautiously.

MR MATTHEW: I think that's right and again it wouldn't be for all forms of behaviour, certainly, but when you're using this type of behaviour where you're making something a penalty contingent on what your primary entrant does, yes, I think it's right that they should be on notice, don't do those things if you think it's likely to have a significant impact in reducing the chances of them coming into this market unless you have good reason for doing it, and that seems to me to be a desirable incentive.

The only issue is -- and it is an important issue -- what you don't want is what makes sense here then to read across into a large range of other cases where the facts may not be as clear-cut and --

THE CHAIRMAN: You get false negatives or is it false positives? I never know.

MR MATTHEW: I think if you have -- you can actually build up a whole framework of rebuttable presumptions that can then be rebutted and all of them carry different directionality.

But to me, yes, I think this case would be a case where if you were to use price cost tests in a very mechanical way, you know, you would have failed to pick up a fairly clear-looking case of anti-competitive foreclosure, and the only reason you would do that is if you felt that the chilling effect was sufficiently great that you should allow a few of these bad ones through such that the majority do better. But as I've said, I would have thought it would be relatively easy to make clear that this sort of arrangements lead you to a different set of balances than would apply if the circumstances were significantly different.

MR FRAZER: You say be cautious in cases like this and test what the likely effects are, but how? How will you do that as an incumbent? In what sense would you be cautious? Where would you draw the line and by what mechanism would you determine the likelihood of having crossed that line?

MR MATTHEW: Well, I think -- I mean, the ideal is that you set out a set of rules so that everybody understands what they are and they're all written down and you can do those.

MR FRAZER: I'm not thinking about the ideal, I'm thinking about in this particular case how would you go about if a price cost test is not appropriate.

MR MATTHEW: In this case I think you would say in a situation of near monopoly, where exclusion would demonstrably have a large impact on the competitive process and a permanent impact, and you're using a method of competition that is fairly self-evidently aimed at deterring that entry and the deterrence is not occurring through cutting prices or anything that's recognisably a sort of -- you know, a pro-competitive, an efficient pricing approach, then you need to have very good justification of what you're doing. And I think you could write those things down and say other firms who may not be in all those positions, who may be thinking of going into a contract where, you know, it's not likely to have those effects or where it's got some good -- reasonably good reason for it, or if all that leads you to saying I'm not really sure whether it passes an AEC test of the type Mr Dryden has laid out, you could use those as well.

It's about defining there are some where the circumstances are sufficiently bad that you are on notice, you don't get the safe harbour, and alternatively that the AEC is a rule, for example, but there is a rebuttable presumption where these other circumstances might apply. It's another way of putting it.

MR FRAZER: Sufficiently bad in terms of the nature of the conduct or the intention of the party?

MR MATTHEW: I think for me it's the nature of the conduct along with the intention and the likely effects. Once you start picking off bits and pieces, you know, I mean, for me in this case you have to move some way away from them before it became, you know, something that looks like it is not anti-competitive foreclosure. But yes, it's the combination of the factors here that makes this case fairly clearly different from a lot of the others that you see, and a lot of the others where abuse of dominance has actually been found.

MR FRAZER: That's clear, thank you.

PROFESSOR ULPH: Mr Dryden?

THE CHAIRMAN: Mr Dryden, I assume you regard that as just vague analysis, unreliable and not very helpful to the incumbent, is that right?

MR DRYDEN: I agree with all of those propositions. Yes, if I can just make a -- yes, a few remarks. Sorry, let me start again. First of all I think there is a vagueness in the structure of what was just put. So it's very, very hard to understand what has just been described as some coherent structured rule of reason approach.

And it's not a -- as has I think already been discussed, it's not a consumer welfare approach in the sense described by Professor Salop, for example. So it lacks much or any structure as far as I can tell, it seems to proceed a little bit on ticking enough boxes or having enough there, which isn't that satisfactory.

There's then the question about whether the elements that are said to be there amount to as much as is suggested. There were a lot of propositions made but some of them were the following.

First, someone exited. Not a sufficient or even necessarily a very contributory factor in itself to distinguishing foreclosure from anti-competitive foreclosure.

Second, intent, described by Professor Vickers in his 2005 paper as fundamentally problematic, the concept of intent. The reason being that intent to exclude in itself doesn't distinguish the anti-competitive act of exclusion or the competitive act of exclusion.

The proposition was that Royal Mail acted with no good reason and there was nothing pro-competitive in its actions, and I disagree with that. I think this is, as I said earlier, a case that has a light side and a dark side, and the light side is that the threat that Royal Mail faced from DDOs was less than the threat it faced from access operators, which is DDOs took away its downstream volumes and undermined its economies of high density in delivery.

The lower the access price that Royal Mail sets for the DDO, where the DDO chooses to be reliant on the Royal Mail, then the more the Royal Mail gives the entrant headroom to compete in the other areas where it chooses to enter.

We can imagine a very extreme scenario where the DDO entrant was given free access, (inaudible) to rely on access everywhere, but if it was given free access, that would fund a vast amount of inefficiency in the areas where it chose to enter. We can equally imagine a situation where the price of access was exorbitant and then it would not enter at all.

So the question is where in that range of access prices for the downstream rival it's appropriate to set the line. And if the line is being set in a place where the incumbent is saying in effect, "I am prepared or I recognise that I have to lose volumes to you, the entrant, where you are more productively efficient than I am, but I don't think that I have to act in a way to lose volumes to you where you are less efficient than I am and I do not have to contribute to your higher variable costs and I do not have to contribute to your duplication of fixed costs", then that's a different way of looking at what's going on which then, in my opinion, kind of creates a benign motive for what's happening.

Again I referred to it earlier. We have the John Vickers 2007 paragraph on fixed costs which says just this. It says pricing that -- in the presence of very high fixed costs, pricing that induces loyalty and concentrates demand on the dominant firm can be good because it can be pro-competitive, but it can be bad. It can be exclusionary.

So the proposition that there can be kind of nothing good in the exclusion of an inefficient entrant, which is the only kind of entry we can be talking about because the as-efficient competitor test ensures efficient entry, the proposition there is nothing good in that is wrong, and it comes back to this weighing exercise that I've referred to a number of times, which is if in an ex-post regime it were appropriate to create headroom for an inefficient entrant, which I don't think it is, it would have to be demonstrated that that was justified in consumer welfare terms, but it hasn't been.

The alternative approach is to say that supporting an efficient entry is really a task for the ex ante regime.

So I think you will gather from that that I disagreed with many of the aspects of the way that Mr Matthew put it.

PROFESSOR ULPH: Mr Parker?

MR PARKER: So I think the start point for me would be to look at the conduct and the way that it works. So the conduct is Royal Mail has introduced -- has raised all prices to get to the NPP1 price in accordance with the business plan for inflation, so all those prices have gone up. It has then said, well, if an end-to-end entrant rolls out sufficiently far, I will charge more to that end-to-end entrant over the full entirety of its access volumes, once you no longer are on NPP1 and you are on APP2.

And it seems to me that it is -- that is liable to foreclose an entrant because the entrant would be very cautious about expanding beyond a level at which it would incur the higher costs. And in practice what we saw was the entrant in question did cease its roll-out and did not then, you know, proceed further whilst it was waiting for this current proceedings to come to its eventual end, and then eventually didn't wait for that.

So against that backdrop it's hard for me to see what the role of a price cost test really is. So if I go back to Professor Salop's world, there's situations which could be characterised as excessive competition where you want to encourage competition but you don't want the -- you don't want the incumbent to go too far so that there's no space left for an entrant from raising rival's costs, which I think this squarely falls in the context of raising rival costs -- if you choose to be a rival above a certain scale you will incur higher costs relative to if you don't.

So at that level it feels to me the start point is there's no consumer benefit there. I accept that in principle there are then objective justification arguments and you can always look at objective justification and that should be part of the analysis. I think that that has largely been dealt with through the process of the USO reviews and whether there was damage to the USO, an inability for Royal Mail to kind of fund that. And I think, if I understand Mr Dryden correctly, that the concern is about the impact on the USO.

It seems to me otherwise we do have evidence of consumer welfare improvements because we have lower prices from Whistl to its customers, and there's -- whilst dynamic efficiency is something that would only have occurred through time, there was certainly a strong expectation in the various documents that entry would provoke dynamic efficiency, it seems to me that if Whistl's coming in and offering lower prices, it's the prices that matter to consumer welfare, it's not the underlying unit costs that are incurred by the industry that go into those prices. Those costs could go up, prices could still come down it's just a matter of the margin being reduced for the dominant firm and the entrant having a certain margin.

So it seems to me that there's a pattern of evidence there that I'm not sure really where the as-efficient-competitor test or the price cost test sits and that would be consistent with the framework of Professor Salop.

I completely agree with Mr Matthew in the sense that yes, this does make it more challenging for a dominant firm to self-assess its own conduct where there isn't a bright line test that can readily be applied, but my experience is there's never a bright line test that can readily be applied in any of these cases and so dominant firms I think would be prudent across the board to think very hard about certain types of conduct, and I'm not sure that -- I'm not sure it's possible to identify ex ante all the possible scenarios that could lead to competition law breaches and nor would it be necessarily I think reasonable to expect authorities to set out such a set of circumstances.

THE CHAIRMAN: It's very important that we understand the differences here. Am I right, Mr Dryden, that what you're telling us is that your evidence has throughout been that on the one hand you think this problem should have been solved by conducting an as-efficient-competitor test, Ofcom didn't do that, but you also think that if they were going to use an in-the-round analysis, they haven't done it right; is that right?

But you would accept that it's a permissible approach for a regulator to take all the evidence in the round, including the economic evidence, and come to a valuable judgement; you accept that's not as easy for an incumbent firm to predict and assess for itself, but in some circumstances that is the only way, because I think you're also saying to us that there will be some situations where there is not a reliable as-efficient-competitor or some other test that gives you an absolutely clear answer in every case.

So the difference is about -- how can I put it -- analytical technique rather than principle; is that -- I don't want to put words in your mouth, but that's the

message I'm getting.
MR DRYDEN: Yes, I think it may be safer if I restate things.
THE CHAIRMAN: I'm sure it's safer if you restate them, but you can't go on indefinitely restating.
MR DRYDEN: I think in an ex-post context --
THE CHAIRMAN: And you've made the point about ex-post. Put that on one side. I accept that it's a somewhat different analysis if we're talking about proposed regulatory control.
MR DRYDEN: Yes. So in that context I think an as-efficient-competitor test is the right test --
THE CHAIRMAN: You still think that, you're not coming off that in any way.
MR DRYDEN: No. I think it's a sufficient test.
THE CHAIRMAN: But?
MR DRYDEN: I think there are two buts. The first but is if I'm slightly wrong about that rather than completely wrong, it would seem that the as-efficient-competitor test would still have some weight alongside other things and of course that's not the position in the decision, the position in the decision is that the as-efficient-competitor test is evidentially useless.
THE CHAIRMAN: So you put it in the basket of all the evidence has to be considered in the round?

MR DRYDEN: Well, So let me have another go, sir. So I think it is the right test, I think passing it is sufficient. I think if I'm wrong about that, it is at least still valuable evidence, alongside other evidential points, because it tells us something. My first CAT report, table 1, I think I tabulate the degree of productive inefficiency that the CCNs would have permitted. So it's giving us information that is valuable information, if one is going to weigh it with other things.

The second "but" is that an alternative to the as-efficient-competitor test that falls within the types of objective tests that have been discussed in literature is a consumer welfare test. That would have been an alternative path for Ofcom. I prefer the as-efficient-competitor test, and as I've said earlier today, I don't think the analysis that's been presented by Ofcom amounts to a proper implementation of the consumer welfare test as described in the literature.

THE CHAIRMAN: Right, but if they'd done a better job, to summarise what you're saying, then as a matter of principle you would accept that it's a valid approach?

MR DRYDEN: Well, I think the -- I prefer the as-efficient-competitor test for --

THE CHAIRMAN: I'm giving you that.

MR DRYDEN: No, I'm sorry, sir --

THE CHAIRMAN: I understand that. I'm just trying to find out what you really think about the other way of doing it, as to whether you really accept that that is a valid approach or not, leaving aside your view of Ofcom's performance.

MR DRYDEN: Yes, I think it is. I think I can just simply say that it is -- I think it could be a valid approach if it was done properly.

I have some concerns about it, whether they amount to invalidity of the approach. That's the reason for my hesitation. So for example, the application of the consumer welfare test would require the dominant company presumably to be able to make some assessment of consumer welfare, and, you know, Ofcom has taken the position that that is not something that the Royal Mail can do. So it's a slightly curious test. Although it has kind of academic attractions, it's a curious test. It's curious to have an objective test where the Regulator's position is that the dominant company that is meant to be following that test couldn't itself apply it.

THE CHAIRMAN: I think the Regulator's answer to that would be that the law doesn't exist to benefit dominant companies, it exists for consumer or whatever welfare standard you apply. That's the short answer to that, isn't it? The ability to self-assess is important, but it's of a secondary order, surely.

MR DRYDEN: I would defer to the tribunal on that kind of question.

THE CHAIRMAN: Mr Matthew, the charge against you is you didn't do a good job, but I think the real question we need to be clear about is -- I think what I'm getting from Mr Dryden is that the as-efficient-competitor test, however constructed and calibrated, provides you with useful information in your in the round analysis, whereas I think the position Ofcom has taken is that the most they have to do is to look at the circumstances and make a judgement as to whether an as-efficient-competitor test can be informative, and once having done that, that is then weighed in the evidence with everything else. Is that a fair summary of your position?

MR MATTHEW: Let me just get it straight. So I think --

THE CHAIRMAN: You are allowed to repeat.

MR MATTHEW: So for me, I mean, the reason you do the as-efficient-competitor test, we discussed them at length, and my personal view is when you have other good evidence that tells you you're looking at anti-competitive foreclosure, you -- you know, the result of the as-efficient-competitor test as a determinative guide has gone, or, you know, you've moved past it, you've implicitly said, "Well, look, even if you passed an as-efficient-competitor test, this is still anti-competitive foreclosure". In that world, it becomes -- the fact that you've passed becomes irrelevant.

THE CHAIRMAN: So not sufficiently informative to be useful, is that your position?

MR MATTHEW: I mean, you could still -- in principle, it might still tell you something about the market circumstances. So you could look at the as-efficient-competitor and say, "Well, look, this tells me that the rival's not as efficient as Royal Mail", but in this case I don't really think that takes you very far. And more generally you could look at analysis of the profitability of entry of the REO, for example, and just seen your as-efficient-competitor test, and you might say, well, that tells us something useful about the position of an entrant and it becomes part of your evaluation of the effects of the conduct rather than being a determinative guide in itself as to whether it's anti-competitive or not.

And what the decision says -- and I agree with it --

is, well, that's a blind alley here, and it's a dead end, because the as-efficient-competitor test just simply isn't telling you anything useful about the real world circumstances of the market at all when it comes to the impact on an entrant.

So to my mind, it's not that as-efficient-competitor test here is relevant but has been ignored, it's we've moved past it. The other interrelations are sufficient to find anti-competitive foreclosure even if an AECT is passed.

THE CHAIRMAN: Mr Parker, is there anything you want to add? Are you in the middle of those positions or what?

MR PARKER: I think the bit I'm struggling with on the as-efficient-competitor in this particular context is I don't think that Mr Dryden and Mr Harman have really done an as-efficient-competitor test, because the as-efficient-competitor should be able to operate at the scale of Royal Mail, national scale and so on.

THE CHAIRMAN: I think Mr Dryden thinks he has.

MR PARKER: I understand there is a difference of opinion here, but it seems to me, if it's as efficient it's as efficient, and that's what we mean.

Then at that point, because the as-efficient entrant is never reliant on Royal Mail, it places no bounds on Royal Mail's pricing behaviour, because Royal Mail can charge any prices it liked to any real world entrant, but the as-efficient entrant would hypothetically never have to rely on access from Royal Mail and so it becomes an entirely unbounded test.

And I think this observation arises because we're in a world where you can't conceive of a realistic as-efficient entrant as Royal Mail. I can see, in a standard vertical squeeze -- vertical margin squeeze world where you can conceive that the entrant coming in can essentially be as efficient as the incumbent on all bases, there's no reason to think that they can't essentially replicate or be as efficient as that incumbent, that an as-efficient-competitor test makes sense. And even there, in some cases, adjustments are made for the kind of non-replicable advantages of the incumbent, if they've depreciated a certain asset that is now at zero cost in their books whereas a -- whereas the entrant isn't able to do that, sometimes adjustment is taken for that, or needs to be taken into consideration.

What that means essentially, I think we're always talking about REO, because when there are no advantages and disadvantages for the incumbent, the as-efficient-competitor and REO come to the same thing.

Because we're in a world here where the as-efficient entrant and the realistic -- some realistic entrants are very different, it seems to me the whole concept and virtue of an as-efficient-competitor test in terms of its bright line benefits for the dominant firm just means you're answering the wrong question, and because of that, I think it's not a very sensible approach to say that is not only sufficient but it's really the only thing -- you know, that's determinative of the case. And it seems to me, in a world where it's very difficult to adjust that in the way that you'd really like to, probably you are better off by looking at the factual circumstances of what happened, you're looking at the mechanism by which anti-competitive foreclosure can occur and the other factual evidence that's out there. So I think that's where I would be.

THE CHAIRMAN: So you're not saying that the test you've described in your opinions, REO or whatever, is the one that would give the answer to this, you're saying the fact that you have to go down the REO route, if there is a route to REO, convinces you that it's not the right road; is that right?

MR PARKER: So I think --

THE CHAIRMAN: Should convince you.

MR PARKER: I think that's right. The purpose of the evidence I put in my report was to say if one does go down -- if one is required to go down a price cost test route, how might one think about applying it in this particular circumstance, but as you'll see there was a limit to what one -- what I could do certainly from my position to be able to adjust that test, but that that would conceptually I think be how you would do it, starting with the premise that a price cost test was required.

THE CHAIRMAN: So you are consumed by your own logic.

MR PARKER: I find this is often the case.

THE CHAIRMAN: Can we do materiality in 12 minutes? We have one more question within this broad topic, don't we, which I think we might like to do today before tomorrow.

PROFESSOR ULPH: We're trying to do it today?

In assessing the outcomes of an AEC test or other economic tool, how should one approach the need for the measurement of materiality? Mr Dryden?

MR DRYDEN: So under an as-efficient-competitor test, the -- if the test is passed then a materiality issue doesn't really arise. If the -- sorry, let me start again.

Under the as-efficient-competitor test, if the two lines in our graph are such that there is headroom for an as-efficient-competitor, materiality doesn't arise. If the effective cost that the entrant has to have goes below the dominant company's cost and we have some negative zone in the graph, a materiality issue arises about whether that zone is deep enough and wide enough to impede the entry of an as-efficient-competitor. That is the conventional approach.

Under the REO/SLEO approach, it seems to me that it's sort of impossible to think about materiality in those terms, because the adjustment is arbitrary in the first place, so the 1, 2, 3p or, if one goes beyond, 4, 5, 6p is arbitrary, so the question of materiality gets bound up with the question of the adjustment. So it's hard to think of materiality in an objective sense.

Under the consumer welfare test, which hasn't been applied, the question would be whether -- I suppose whether the factual level of consumer welfare was sufficiently clearly below the counter-factual level of consumer welfare without the conduct that we felt able to say the conduct has reduced consumer welfare to some relevant standard like the balance of probabilities.

That's going to be a slightly trickier exercise, because assessing consumer welfare, as we've discussed earlier today, and determining the counter-factual are trickier exercises, so maybe that gets us into preponderance of evidence territory or some concept like this.

On the Ofcom action approach, it's hard to see how materiality enters, because I don't think the approach, as I've said already, has much discernible structure.

We haven't yet really talked about my view of if there is an underlying structure what it is, but an element of it, I think, is that Ofcom is saying that compared to the counter-factual of uniform prices, the profitability of an entrant is reduced and that leads to perhaps a materiality discussion about that reduction. But there will, from this kind of conduct, there will I think generally be, as there are with retroactive rebates and etc or anything that induces loyalty, there will be -- it does make the entrant's life more difficult. So then a lot would hinge on materiality and I don't believe the objective sense in which one would assess it. But I struggle there because I think it all emanates from the wrong test so I can't really give a good answer to materiality premised on the wrong test.

MR MATTHEW: It might be helpful just to pick up from there. So I agree in this context. I think it does go to essentially your evaluation of the effects of the conduct. So essentially, to what extent did the price differential materially increase the costs or reduce the profits of entry such that the likelihood of that entry occurring declined to some appreciable amount, and that's what I think of and that's the discussion that arises in Mr Harman's work.

PROFESSOR ULPH: Mr Parker?

MR PARKER: I mean, I suppose the starting point would be to look at the actual effect of the conduct and what that had on the actual entrant to identify materiality. What we saw was once the price differential was announced there was a flurry of activity over that weekend which involved putting various plans on hold and LDC inserting an MAE clause that said basically we have the right to withdraw if the price differential comes into force, and it -- I mean, it's for the tribunal to judge, but it seems to me that those are quite material effects happening at the time and that they happened in relation to the entrant, and it's -- you struggle with the idea that a price cost test is the only way that you can identify materiality of impact when you also have facts.

PROFESSOR ULPH: I think Mr Dryden was saying the price cost or an AECT test. In some sense materiality doesn't arise in that context apart from this issue about the zones. But do you want to ...

MR DRYDEN: Yes, I'd just like to follow up. So the way that I think of this, which I think is quite widespread, is that there are two stages to the analysis. The first stage is whether the conduct was objectively abusive, and for that we need a test, an objective test, or let me say at least we would ideally have an objective test of what is abusive foreclosing conduct as distinct from non-abusive foreclosing conduct. And the things I am talking about are candidates for that objective test. Sacrifice test no one is contending for, as-efficient-competitor test, consumer welfare test.

And with all of those tests, they will produce results and we can then have an appreciability or materiality question about the outcome of those tests and how strong the results have to be to determine something is a fail rather than a pass. That's the way I was answering for the price cost test. That is step one of the analysis.

Step two of the analysis, which arises only if I found the conduct to be abusive, step two, which one gets in some cases, is a question of whether it has material market effects, and that's a different question. And sometimes the answer to that, even if the answer to the first is that there has been conduct that would be abusive, sometimes the answer to the second part is it didn't have material market effects.

So an example would be some retroactive rebate contracts that create a big negative zone in the graph very clearly, which we assess at step 1 as being in itself kind of abusive conduct, but the second stage of that only had 5% market coverage. Those contracts, the conduct may not lead to any material or appreciable effects on the market and therefore may not be condemned. But it seemed to me that Mr Parker was sort of doing these two things simultaneously, and I think they have to be kept separate.

The fact that we see the actual entrant in this case considering exit, actually exiting, etc, isn't part of the materiality test of whether the conduct was abusive. It may well be part of the materiality assessment of whether, if the conduct was abusive to some objective standard, it led to material market effects, which I haven't analysed.

PROFESSOR ULPH: So your position is two levels of materiality test that you have to do, first of all about abusiveness of the behaviour, and secondly about the market impact of the behaviour.

MR DRYDEN: Correct.

PROFESSOR ULPH: Okay.

THE CHAIRMAN: You don't really think this is a case of raising rivals' costs at all, is that right?

MR DRYDEN: No, I think it could be, and I don't think that anything I've said -- I don't think it necessarily is, I think it could be, and I don't think anything I've just said is contingent.

THE CHAIRMAN: If it were, should we attach any significance to that? Does it affect the way we should look at it?

MR DRYDEN: Well, if it were -- and we'll have to park the question of whether it is, but if it were, then I think some margin squeeze cases are characterised as raising rival costs, and some retroactive rebate cases are characterised as raising rival costs.

THE CHAIRMAN: So we still have to go through the same analysis.

MR DRYDEN: So you have to go through the same analysis.

THE CHAIRMAN: I think we might draw a line there, if that's not a risky phrase. Thank you very much for your stamina today. I appreciate that we're asking a lot of you all and I'm very grateful. We will continue tomorrow on the same basis. Mr Beard?

MR BEARD: Just a clarification. Is it appropriate and permissible, and I wanted just to check, that the experts can be provided with copies of the transcript of today? Obviously there will be no contact to discuss evidence.

THE CHAIRMAN: That's fine.

MR BEARD: I'm grateful.

THE CHAIRMAN: Absolutely. And tomorrow, we will -- well, I don't want to commit us unwisely. We will try and give some indication of what we think we have learned and there will be an opportunity obviously for counsel to ask any clarificatory questions as a result of this before we get into the next stage, which is individual examination and cross-examination. That's understood by everybody, is it? We'll do that at the end, if we may.

All right, thank you very much then.

(4.31 pm)

(The hearing adjourned until 10.30 am on Wednesday,

26 June 2019)

INDEX