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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1299/1/3/18

Victoria House,
Bloomsbury Place,
London WC1A 2EB

1 July 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

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HEARING – DAY 14

APPEARANCES

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.

Monday, 1 July 2019

(10.28 am)

Housekeeping

THE CHAIRMAN: Mr Beard, good morning.

MR BEARD: Good morning, Mr Chairman, members of
the tribunal.

THE CHAIRMAN: Is this week 4? I've lost count.

MR BEARD: I think it is, yes.

Before we turn to the next stage of evidence, I just
thought I would indicate where we are in relation to
Mr Harman. Unfortunately I don't think we will have
a concrete update for the tribunal until Friday.

THE CHAIRMAN: I don't think we were expecting one, to be
fair.

MR BEARD: No. Just in practical terms, if Mr Harman is
able to give witness evidence on the Monday, then we
carry on; if not, then perhaps on the Friday we will
need to have an exchange about how we deal with matters
otherwise. I think you had already adverted to the
possibility that that might need to be done in writing,
but we can perhaps leave that until the end of this
week.

THE CHAIRMAN: Yes. It might be a written exchange on
Friday to be considered on Monday.

MR BEARD: Understood. One of the things I just wanted to

1 highlight was, even if we're into the territory of
2 making written exchanges in relation to Mr Harman's
3 evidence on the Friday for consideration on Monday, it
4 seems to me it's unlikely that we are going to be able
5 to proceed with closings on the previous timetable.

6 That was the only reason I mentioned it specifically.

7 THE CHAIRMAN: I think I extended the timing indefinitely to
8 cater for that.

9 MR BEARD: Absolutely, you did, but I just thought I would
10 update the tribunal as to where we were.

11 THE CHAIRMAN: Okay.

12 MR BEARD: I don't have any other matters for the tribunal.

13 THE CHAIRMAN: Does anybody else have any information to
14 impart? No. Right, then Mr Holmes.

15 MR HOLMES: Thank you. We come, then, to Ofcom's expert
16 witness, Mr David Matthew. Could he be called, please.

17 MR DAVID MATTHEW (affirmed)

18 THE CHAIRMAN: Thank you, Mr Matthew. Make yourself
19 comfortable.

20 Examination-in-chief by MR HOLMES

21 MR HOLMES: Could Mr Matthew please be handed bundle C3.

22 Mr Matthew, if you could turn within that bundle to
23 tab 5. The tribunal has this document in several places
24 and it may be using the concurrent evidence bundle. If
25 so, the relevant reference is concurrent evidence

1 volume 2, tab 8. If you could turn, Mr Matthew, please,
2 to internal page 55, rolling page 336, do you see there
3 a statement of truth --

4 A. I do.

5 Q. -- and a signature dated 17 December 2018? Is that your
6 signature?

7 A. It is.

8 Q. Is this your report in these proceedings?

9 A. It is.

10 Q. Could you turn then to tab 1 of the bundle. Do you have
11 there a document entitled "Joint Expert Statement"?

12 A. I do.

13 Q. If you could turn within that document to page 2, do you
14 see a signature on the left-hand side of the page?

15 A. I do.

16 Q. Is that your signature?

17 A. Yes.

18 Q. Is this your joint expert memorandum prepared together
19 with Mr Neil Dryden and Mr David Parker in these
20 proceedings?

21 A. Yes.

22 Q. If you could turn on to tab 2 of the bundle, do you have
23 there a document entitled "Joint Statement of
24 Mr Greg Harman, Mr David Matthew, Mr David Parker"?

25 A. I do.

1 Q. If you could turn within it to page 113, do you see
2 there a declaration?

3 A. I do.

4 Q. Is that your signature?

5 A. It is.

6 Q. Is this your joint expert joint statement together with
7 Mr Harman and Mr Parker?

8 A. Yes.

9 Q. Do you have any corrections or observations that you
10 wish to make on any of these documents?

11 A. No.

12 MR HOLMES: I'm grateful. If you could stay where you are,
13 Mr Matthew, I believe that Mr Beard may have some
14 questions for you.

15 Cross-examination by MR BEARD

16 MR BEARD: Mr Matthew, good morning.

17 You have got your witness statement there in
18 bundle C3, I think. Can I just pick up paragraph 5.
19 You say in paragraph 5:

20 "In terms of my involvement in this case prior to
21 the decision, I was not responsible for the overall
22 economic analysis which was led by other economic
23 directors of Ofcom's competition group. From 2017,
24 I had oversight of the completion of the economics
25 evaluation of Royal Mail's submissions relating to

1 whether there was a need to carry out an as-efficient
2 competitor price/cost analysis in this case and of the
3 AEC price/cost analysis evidence submitted by Royal Mail
4 during the investigation."

5 So I'm right in understanding from that that you
6 became involved in this case in 2017; is that correct?

7 A. Yes.

8 Q. Thank you.

9 So you weren't involved in the preparation of the
10 statement of objections on that basis?

11 A. No.

12 Q. No. Just in terms of that, in paragraph 12 you refer to
13 the material which you read in preparing this witness
14 statement. You don't refer there to the statement of
15 objections. Have you now read the statement of
16 objections, Mr Matthew?

17 A. I haven't read it recently. I think I may have scanned
18 sections of it earlier, but I can't remember exactly.

19 Q. But not for the purposes of preparing this report?

20 A. No.

21 Q. Could we -- we're going to be coming backwards and
22 forwards to the witness statement -- just go to the
23 decision, if we may, which I have in bundle C1 at tab 1.
24 You will be familiar with the overall structure of the
25 decision, I'm sure. What I just wanted to confirm was:

1 if you go to page 225 ...

2 A. Is that the internal ...?

3 Q. Sorry, I'm using the red external numbering, it is 223

4 of the internal.

5 A. The likely distortive effects?

6 Q. Yes, so this is section 7E. I just wanted to be clear

7 which parts of the decision, where you say in your

8 statement that you had oversight of, was it the whole of

9 7E or was it really the focus from 7.182 on page 236?

10 A. So 7.182 is the section specifically on the as-efficient

11 competitor test.

12 Q. So was that the focus of your consideration in carrying

13 out what you say is the oversight of the completion of

14 the economics evaluation, is it that section 7.182

15 through to 7.202?

16 A. Yes, at the time that was the primary focus. Obviously

17 I was familiar with the surrounding material as well.

18 Q. But your focus was on this section; thank you.

19 Now, you're here on behalf of Ofcom, but you're

20 obviously not a lawyer and so I'm not going to ask you

21 about proper interpretation of case law or, for example,

22 the law in the recent Intel judgment. But I do notice

23 in your witness statement that there are various

24 references to European Union guidance on priorities

25 concerning the enforcement of Article 82; yes?

1 A. That's correct.

2 Q. You pick it up at paragraph 34 in your witness
3 statement, and you deal with it at various other places
4 we will come back to.

5 Now, that material you refer to in your witness
6 statement, we don't see any reference to that EU
7 guidance in the section I've just referred to, or indeed
8 in section 7 at all, do we?

9 A. Well, you have the advantage of me, I haven't recently
10 checked. If you tell me there is no reference to it,
11 then I'll take it as read.

12 Q. But I just want to be clear. You say you had oversight
13 of those passages, and in particular we've just agreed
14 7.182 through to 7.202, and you are well aware there is
15 no reference in those passages to any of this guidance,
16 is there?

17 A. Again, I would need to check, but I'm happy to take it
18 as read that there is no references.

19 Q. So in relation to the crucial passages in this decision
20 concerned with the relevance or otherwise of the AEC
21 test, there is no reference to the guidance you now
22 highlight in your witness statement, is there?

23 A. Again, if you tell me that's true, I'm happy to accept
24 it.

25 Q. But that guidance is highly relevant, isn't it, at the

- 1 very least, Mr Matthew?
- 2 A. The guidance is highly relevant to what, exactly?
- 3 Q. Well, to the consideration of whether or not an AEC test
- 4 should be carried out, was relevant to the current case
- 5 and should have been taken into account, wasn't it?
- 6 A. Well, I mean, the Article 82 guidance is a useful piece
- 7 that's well known, and most economists in this area have
- 8 read it and are familiar with it. I wasn't aware it had
- 9 a reading that required it to be dealt with in a section
- 10 like that.
- 11 Q. So in this section, you're purporting to apply
- 12 Article 102, and this is key guidance in relation to
- 13 102, but you don't take it into account at all in this
- 14 section, do you?
- 15 A. As I said, it's not really a matter for me as to whether
- 16 or not Ofcom was required to go through the guidance in
- 17 its discussion in that section.
- 18 Q. But you didn't actually think about that guidance when
- 19 you were setting out that section, did you?
- 20 A. Well, as I said, in general most economists in this area
- 21 are familiar with the guidance and, yes, I mean, I would
- 22 have read it at the time and been familiar with it.
- 23 Q. But you didn't have regard to it when you were setting
- 24 out your position at Ofcom in relation to these
- 25 sections, did you?

- 1 A. Well, as I said, I certainly had regard to it as
2 contextual material on policy in this area. I didn't
3 think it -- well, I'm afraid I don't - I can't answer
4 the question of whether I ought to have gone through it
5 specifically in this section. There is a decision --
- 6 Q. Are you saying that you did have regard to it -- I am so
7 sorry, I overspoke.
- 8 MR HOLMES: Could he be allowed to speak, please?
- 9 MR BEARD: I thought he had finished. Of course.
- 10 A. Well, there is a discussion, I'm just flicking through
11 in that section, about the legal framework.
- 12 Q. There is.
- 13 A. Which wasn't obviously for me.
- 14 Q. No.
- 15 A. And that's the place, I imagine if it was thought to be
16 guidelines, it would be perhaps discussed in that
17 section.
- 18 Q. It's not, Mr Matthew.
- 19 A. I said that's not my section.
- 20 Q. So I just want to understand: did you have regard to
21 this guideline when you were making this -- or this
22 guidance -- assessment?
- 23 A. I had regard to it, as the economics director, familiar
24 with the guidance at the time and --
- 25 MR HOLMES: Sir, I hesitate to interrupt. Mr Beard I think

1 suggested that the guidance wasn't referred to in the
2 legal framework section of the decision. That's not
3 correct.

4 MR BEARD: No. I think --

5 MR HOLMES: I don't want the questions to be on a false
6 basis.

7 MR BEARD: I'm so sorry, I think Mr Matthew was referring to
8 that first part of -- I may have misunderstood, but
9 I understood that Mr Matthew was referring to the first
10 part of that section at 7.192.

11 Am I misunderstanding?

12 A. That's what I was referring to.

13 Q. Why?

14 A. Within this section D --

15 Q. Yes, that's what I understood.

16 MR HOLMES: Apologies.

17 MR BEARD: Thank you.

18 A. Obviously there are other discussions of the legal
19 framework in the decision.

20 Q. Yes. Mr Matthew, none of those --

21 A. On the question --

22 Q. I am so sorry, Mr Matthew.

23 A. On the question you put, I mean, if you are suggesting
24 to me that the section was written and my role was taken
25 without understanding the existence of or what that

1 guidance says, then that's wrong, obviously I was aware
2 of it.

3 Q. Well, you say you were aware of it, but you refer to it
4 specifically in your witness statement, but there is no
5 reference at all to the approach or structure set out in
6 that guidance in this section, is there?

7 A. Again, if you tell me it's not referred to in this
8 section, I'm happy to accept it.

9 Q. So you didn't seek to follow the structure of that
10 guidance in this analysis, did you?

11 A. The -- well, it didn't set out -- you're taking me back
12 to the time, but I don't think you set out to try and
13 follow step by step the structure of that guidance,
14 I didn't understand it played that role. We were
15 familiar with it and clearly quite a large part of what
16 Ofcom has said in the case more generally, and I forget
17 whether it's specifically in that section or not,
18 clearly are things that you find in the guidance, and
19 many of the points are things that are discussed in the
20 guidance.

21 Q. We will come back to that, Mr Matthew. Just picking up
22 some of your references in your witness statement, if
23 you go on to paragraph 66 in your witness statement.

24 A. Yes.

25 Q. This is under your heading "Academic debate about

1 price/cost tests", and you say at 306:

2 "Others argue that AECTs [this is the last two
3 sentences of 306] provide a useful filter that might be
4 applied quite broadly. The Commission's enforcement
5 priorities guidance envisaged the use of price cost
6 tests across a range of forms of conduct that would
7 otherwise constitute vigorous price competition. The
8 debate on what this should mean for policy design is
9 unsettled."

10 Just so that I understand that sentence properly,
11 the first of the sentences I read, what you are saying
12 is that you understand from the guidance that it does
13 suggest that AECTs should be used as at least a useful
14 filter in relation to abuse cases, but you think that
15 there is an exception where the conduct in question is
16 not vigorous price competition; am I reading that
17 correctly?

18 A. Well, I think it says, working from memory, that the
19 introduction to the section where the enforcement
20 guidelines talk about the need for AECs is put in the
21 context of vigorous price competition can deliver
22 benefits to consumers, so we need to have AECs as
23 providing our filter. And that's what it says there.
24 It would seem to me to follow that where you have
25 conduct that is not vigorous competition, then the

1 rationale put for using AECs would fall away.

2 Q. I understand.

3 A. And if I remember rightly, there is a preceding
4 paragraph to that that does talk about some types of
5 conduct that -- where the Commission does give
6 an example in the guidance as to these sorts of things
7 can only restrict competition and don't deliver
8 benefits. So those you don't need to go through a sort
9 of an effects analysis.

10 Q. I see. Just to pick up two points here. We're going to
11 come to the guidance, Mr Matthew. So here you are
12 saying why the distinction in the guidance is important,
13 and identifying this vigorous price competition
14 distinction, aren't you?

15 A. Well, I'm here referring to the guidance as part of the
16 broader academic debate about when one should use
17 price/cost tests, which I say for me seems to be
18 unsettled, and I'm observing the Commission is arguing
19 in these guidance, in its guidance that AECs might be
20 used quite broadly where you are dealing with conduct
21 that might otherwise constitute vigorous competition.

22 Q. So in this paragraph you footnote the guidance itself
23 and you footnote in particular paragraphs 23 to 27;
24 that's correct?

25 A. Yes.

1 Q. Now, you were in court, weren't you, when Mr Parker was
2 giving evidence, Mr Matthew?

3 A. On Friday, yes.

4 Q. Yes. Thank you. You were certainly in court when he
5 was giving evidence during the course of the hot tub as
6 well, yes.

7 If you could be provided with the cross-examination
8 bundle for Mr Parker, please, I'm just going to go to
9 the guidance, it's at tab 2 in that bundle. I don't
10 know whether the tribunal used that or authorities
11 bundle 1, tab 8, if you were marking that one up on
12 Friday you may want to go back there.

13 (Pause)

14 Thank you. If we may just turn on to page 99 in the
15 external bundle numbering, you will see there under the
16 heading "Price-based exclusionary conduct" paragraphs 23
17 to 27 to which I took Mr Parker.

18 So those are the paragraphs you footnoted in your
19 witness statement as being the relevant paragraphs
20 dealing with the question of whether or not AECTs
21 provide a useful filter from the European Commission's
22 point of view; is that correct?

23 A. Yes.

24 Q. What you see there in paragraph 23, as I went through
25 with Mr Parker, is:

1 "Considerations in paragraphs 23 to 27 apply to
2 price-based exclusionary conduct."

3 Then we have this sentence:

4 "Vigorous price competition is generally beneficial
5 to consumers."

6 You in your witness statement have fixed on that
7 phrase, haven't you, as being the threshold limit for
8 the application of this section of the guidance as you
9 understand it? Am I understanding correctly?

10 A. I'm not entirely sure what you mean by threshold limits,
11 but yes, it seems to me this section flows from a view
12 that you have a range of practices that are potentially
13 beneficial for consumers, and you're seeking to draw
14 a line as to when they're found to move from being
15 pro-competitive to anticompetitive.

16 Q. When I say threshold limit, what I mean is that you are
17 saying in your witness statement that your approach to
18 this guidance is that it's only relevant to apply this
19 guidance where you're dealing with conduct that amounts
20 to vigorous price competition; am I understanding
21 correctly?

22 A. Well, you may be reading too much into my statement.
23 It's not intended to be a forensic deconstruction of
24 this guidance and to set out precisely what we think the
25 guidance says. I simply haven't read it at that sort of

1 level of detail. All I'm saying is it seemed to me that
2 the discussion, which is a slightly -- the alternate
3 version of what I think you are suggesting is that the
4 discussion of when to use AECs flows from a view that we
5 are talking about practices that could constitute
6 vigorous price competition.

7 Q. So just to be clear, you say it's not intended to be
8 a forensic distinction and you hadn't read it in that
9 way, you hadn't intended it in that way. You certainly,
10 at the time when you were reviewing the decision,
11 weren't focusing on this distinction, were you?

12 THE CHAIRMAN: I think he used the word "deconstruction",
13 that's what I heard.

14 MR BEARD: I'm sorry. I apologise, I misheard.

15 But you didn't, at the time you were overviewing the
16 decision, focus on this distinction and whether or not
17 this guidance should apply, did you?

18 A. I mean, if you're asking me as a matter of recollection,
19 I can't remember precisely what stage I would have
20 thought about the guidance, but stepping back, the view
21 I had was the conduct didn't look like vigorous price
22 competition.

23 Q. Well --

24 A. Well, and that -- I think it's stated in the decision,
25 and that therefore the reason for using an AEC test

- 1 didn't seem to apply.
- 2 Q. So in the decision the phrase "vigorous price
3 competition" is not used, is it, Mr Matthew?
- 4 A. I thought it did refer to vigorous price competition in
5 various places, but maybe I'm wrong. I thought it did.
- 6 Q. What you have here is you, in your witness statement,
7 explaining why it is you think that this section,
8 relevant guidance, dealing with whether or not an AEC
9 test is relevant and/or should be applied, in your
10 witness statement you're explaining why it shouldn't,
11 aren't you?
- 12 A. Well, if we're talking about this paragraph of the
13 witness statement, then it's a slightly narrower
14 observation, but generally my witness statement does say
15 very clearly that where we're dealing with practices
16 that are not vigorous price competition, the need for
17 an AEC falls away.
- 18 Q. Just to be clear, nowhere in the decision, whether in
19 the AEC sections or elsewhere, is there any reference to
20 paragraphs 23 to 27 of this guidance, Mr Matthew. In
21 those circumstances, isn't it right that you didn't have
22 regard to these paragraphs when you were preparing your
23 decision?
- 24 A. As I said, when we prepared the decision, I had in
25 mind ... I was fully aware of the existence of this

1 guidance, the widespread discussion it gets, the
2 emphasis it gets, the fact that I think -- and you will
3 correct me if I'm wrong -- but some of Royal Mail's
4 submissions and Mr Dryden's 2015 reports cites them as
5 a motivation for why he uses an AEC. Maybe I'm
6 misrecollecting there, but I thought it did.

7 So, yes, we were aware of it, and I was, and while
8 we may -- while I may not have specifically referenced
9 these paragraphs, did think about it. You know, we
10 thought about that evidence, we thought about whether it
11 was necessary to conduct an AEC, and we thought about
12 the AEC that -- material that Compass Lexecon and
13 Mr Harman put to us.

14 Q. Let's just take a step back in this guidance, because in
15 your -- in the earlier framework sections, albeit not
16 considering AEC, there is reference to paragraph 19 of
17 this guidance, which Mr Parker referred to, and you will
18 recall perhaps on Friday that Mr Turner, in
19 re-examination, was keen to take Mr Parker to
20 paragraph 20 of the guidance, which talks in general
21 terms about the sorts of material that the Commission
22 will take into account in carrying out an assessment,
23 and Mr Turner was also very keen to take Mr Parker to
24 paragraph 22, which I think you were just referring to,
25 Mr Matthew, which states:

1 "There may be circumstances where it is not
2 necessary for the Commission to carry out a detailed
3 assessment before concluding that conduct in question is
4 likely to result in consumer harm. If it appears that
5 the conduct can only raise obstacles to competition,
6 that it creates no efficiencies, its anticompetitive
7 effect may be inferred. This could be the case, for
8 instance, if the dominant undertaking prevents its
9 customers from testing the products of competitors or
10 provides financial incentives to its customers on
11 condition that they don't test such products or pays
12 a distributor or a customer to delay the introduction of
13 a competitor's products."

14 So these are all specific conditions or restrictions
15 that are being considered as being imposed by a dominant
16 undertaking, and it's not talking there about
17 price-based exclusionary conduct, is it?

18 A. Well, it's talking about -- well, firstly you asked me
19 about paragraph 20, so paragraph 20 is going through
20 a series of sensible criteria that go to whether we can
21 think about whether foreclosure is likely to arise.
22 Paragraph 22 is talking about conduct that can only
23 raise obstacles to competition.

24 I mean, there are pricing versions of obstacles to
25 competition, ie pricing practices that can only raise

1 obstacles to competition and do not generate
2 efficiencies or benefits for customers, and one of the
3 points in discussion here is that imposing a penalty
4 where it's clearly a penalty falls into that category.

5 Q. We will be coming back to that -- I'm sorry.

6 A. The fact that that involves a price and a contractual
7 term seems to me doesn't mean it's not capable of being
8 something that you say, "Well, I'm struggling to see
9 here where the benefits to competition could be that
10 I need to trade off", so the reasons for AECs that the
11 guidance then goes on to discuss don't seem to apply.

12 Q. So you are saying that paragraph 22 is talking about
13 some sort of per se infringements and you're saying that
14 certain pricing infringements can be per se
15 infringements as well; is that broadly right?

16 A. Well, I don't think about it as per se or not. I just
17 think that there are certain ... in the category of
18 conduct that looks like it might well be
19 anticompetitive, so you're going to think about the
20 magnitude of impact exact and the context and the
21 intent, et cetera.

22 Alongside that, as part of that in the rounds,
23 pricing versions can be there, it's not just non-pricing
24 conduct that could be -- have to be solely distortionary
25 of competition.

1 Q. I see. Let's just go back to paragraph 21, Mr Matthew:

2 "When pursuing a case, the Commission will develop
3 the analysis of the general factors mentioned in
4 paragraph 20, together with the more specific factors
5 described in the sections dealing with certain types of
6 exclusionary conduct and any other factors which it may
7 consider to be appropriate."

8 Now, that paragraph is indicating that the overall
9 general starting point for analysis will be the factors
10 in paragraph 20, but where there are specific examples
11 and approaches described further below, the Commission
12 will apply those ordinarily, isn't it?

13 A. Well, it says "together with the more specific factors".

14 Q. Yes, "together with".

15 A. So ...

16 Q. So what's being said here in this guidance, Mr Matthew,
17 is that it's not enough when you are talking about the
18 types of conduct specified further below just to stop at
19 paragraph 20 considerations, isn't it?

20 A. It doesn't say it's not enough. It's says it's going to
21 think of those things, along with specific factors
22 dealing with certain types of exclusionary conduct, by
23 which I think it means vigorous competition.

24 Q. Does it?

25 A. And any other factors it may consider to be appropriate,

1 which I'm not sure what that is limited to.

2 Q. So together with the specific factors described in the
3 section dealing with the certain types of exclusionary
4 conduct, and below we have a certain type of
5 exclusionary conduct, price-based exclusionary conduct,
6 described in paragraphs 23 to 27.

7 The reality is, Mr Matthew, you didn't have regard
8 to this, did you, when you were entering into the
9 decision?

10 A. I said several times I was familiar with the guidance,
11 it was raised with us, we thought about it, and the
12 decision is made in light of that, you know, that
13 context.

14 Q. Are you --

15 A. So I don't think it was ignored.

16 Q. Are you saying that when you took into account the
17 guidance you ignored the fact that the Commission said
18 here that the way to deal with the types of conduct that
19 are specified below and the specific factors to be taken
20 into account, you should just ignore that?

21 A. I don't think we -- I ignored anything.

22 Q. Well, Mr Matthew, what this is saying fairly clearly,
23 isn't it, is that alongside any general consideration,
24 when you are dealing with something like price-based
25 exclusionary conduct, you need to take into account

1 specific factors that are set out in the subsequent
2 parts of the guidance, and you didn't do that, did you?

3 A. Well, we took account of the AEC analysis that was put
4 to us.

5 Q. In what way did you take account of it, Mr Matthew?

6 A. We gave thought to whether an AEC test was necessary in
7 this case, alongside the other evidence, and we looked
8 at the evidence itself and what it told us about the
9 real world impact that the conduct was likely to have,
10 and that is discussed in the decision. I do have that
11 paragraph in my mind, it's 7.200, where we decided this
12 doesn't tell us anything useful about how the conduct
13 would have affected the incentives of the real world
14 entrant.

15 Q. I see. So just to be clear -- we will come back to
16 7.200 -- although there is no mention of any of these
17 paragraphs in the decision, 23 to 27, and there is no
18 specific reference to the consideration being referred
19 to in 21, at least in the AEC section, and there is no
20 statement in relation to vigorous price competition
21 being a key threshold in your view in that decision,
22 nonetheless you were having proper regard to this
23 guidance?

24 A. As I said, I had regard to it, as to whether the
25 decision as a whole read legally had the proper regard,

1 that's not a question I can answer.

2 Q. That can be a matter for submission in due course.

3 Now I just want to pick up this phrase "vigorous
4 price competition" that you have picked up in your
5 witness statement and identified in paragraph 23. You
6 will see in the guidance, after the discussion of
7 price-based exclusionary conduct, there is a discussion
8 of specific forms of abuse starting with exclusive
9 dealing. Under A, "Exclusive Purchasing", and under B
10 on page 101, "Conditional Rebates". Do you see that,
11 Mr Matthew?

12 A. Yes.

13 Q. Now, I just want to understand, is it your position that
14 all conditional rebates should be seen as vigorous
15 pricing competition?

16 A. No. It's my position that conditional rebates might be
17 a form of vigorous pricing competition, but they might
18 not be.

19 Q. So when in this section the Commission talks about the
20 approach to analysis of conditional pricing practices,
21 in particular on paragraph 41 -- you might just want to
22 read that.

23 (Pause)

24 A. Yes.

25 Q. You are suggesting that there is actually a prior

1 question that the Commission has to ask, which is: is
2 the conduct in question vigorous price competition? If
3 it is, then we apply the methodology explained in
4 paragraphs 23 to 27. Am I understanding correctly?

5 A. I think you have to take them together, and if you have
6 evidence that it -- well, let's think about it. If
7 there is, if it isn't and if we're not sure.

8 So if it is vigorous price competition and by that
9 I mean the conditional rebate scheme is fairly clearly
10 a mechanism for placing heavy downward pricing pressure
11 in a way that wouldn't be possible if, for example, you
12 required the dominant firm to set uniform prices, so
13 conditional pricing becomes a mechanism for price
14 discrimination, then you would, I think, be thinking
15 about AEC territories, because the issue would be: this
16 is lower pricing and you think about whether or not
17 that's capable of foreclosing --

18 Q. Well --

19 A. -- then you have other cases where I think you can say
20 fairly -- it seems not to be vigorous price competition,
21 I think this is one, where the practice is essentially
22 not trying to cut the price but instead is using the
23 mechanism that conditional rebates give you to set
24 a penalty if somebody stops buying from you. You don't
25 cut your price, you keep your price at, say, your profit

1 maximising monopoly level and you say "Well, if you stop
2 buying from me, I'm going to raise it even further".

3 Then you have those in the middle where I agree it's
4 going to be hard to tell, and then you have a choice
5 about which end of the telescope you want to look at it.

6 Q. I see. As you said, you were in court when I was asking
7 Mr Parker questions. I went through various elements of
8 the Commission's approach in the decision in Intel and
9 the circumstances there, and I don't suppose you dispute
10 that in Intel there were very high barriers to entry, do
11 you?

12 A. I haven't reviewed Intel. I understand there were some
13 factors in Intel that would point to foreclosure being
14 possible.

15 Q. Well, that's something of a narrow answer, isn't it?
16 You accept that in Intel there were very high barriers
17 to entry, as you understand it, don't you?

18 A. I'm happy to accept, if that was the finding. I'm
19 sorry, I haven't looked at Intel.

20 Q. And Intel was overwhelmingly dominant; you understand
21 that to be the case too, don't you?

22 A. Intel, from memory, it had a high share, 70%.

23 Q. 70% to 80%, yes. And there were very large economies of
24 scale?

25 A. There are, in chips. If you are asking me about Intel,

1 and this is as far as the extent goes, those were
2 features, I think there was also some evidence that they
3 were trying to hide the strategy and that it was --
4 there was some evidence of intents, though I am afraid
5 I can't remember precisely what that was or what the
6 nature of what they were intending to achieve.

7 There was also a discussion of how much of the
8 market was covered and whether that was an important
9 part of the market, and there were observations about
10 what actually happened in the market and the -- I think
11 Intel made the point that AMD had continued to grow its
12 share, or at least its revenues, I can't remember which.

13 Q. Yes.

14 A. And what you had was essentially there was
15 an established competitor, so you had somebody who was
16 in the market, and some of the things I read suggested
17 that the sort of, the arguments that this might lead to
18 serious real effects on that rival were inconclusive.

19 Q. I think you --

20 A. I'm sure I read that in the legal opinion about it.

21 Q. Just to be clear, so you recognised that it was very
22 high barriers to entry, overwhelmingly dominant, large
23 economies of scale, it was an unavoidable trading
24 partner which led to the non-contestable share issues;
25 correct?

- 1 A. I think, yes, I think that's right.
- 2 Q. There was a real vulnerability of this market being
3 subject to exclusionary conduct?
- 4 A. I am afraid I can't remember what it said about that.
- 5 Q. But all of those concepts would lead to there being
6 a real vulnerability to the market being subject to
7 exclusionary conduct, wouldn't there?
- 8 A. Well, they might do, but they might also not. It would
9 depend on how vulnerable you felt the rival was and how
10 the conduct was likely to impact that vulnerability.
- 11 Q. As you have already said, the allegation was that there
12 was concealment and there was specific targeting of
13 strategic customers in order to deter the emergence of
14 a scale entrant in the market, wasn't there?
- 15 A. Again, I can't remember the specifics of what the
16 finding was on that.
- 17 Q. Let's just go to the decision, if we may, at
18 paragraph 7.199.
- 19 So this is the third of the reasons. The first of
20 the reasons given in relation to whether or not it's
21 necessary or appropriate to undertake a price/cost test
22 are legal, so I'm not going to question you on those.
- 23 The second is concerned with this notion of a low
24 pricing practice, which we have already started looking
25 at, and I will come back to.

1 The third:

2 "As we have explained in detail in subsection 7(d)
3 above, the relevant market in this case was
4 characterised by high barriers to entry, in particular
5 given Royal Mail was and remains overwhelmingly
6 dominant, benefitted, and still benefits from,
7 significant economies of scale and scope, and was
8 an unavoidable trading partner with control over
9 an indispensable input for potential scale entrants into
10 the bulk delivery market. Thus, potential entry into
11 the bulk delivery market was vulnerable to exclusionary
12 conduct."

13 Well, you would agree, wouldn't you, that the
14 position here on your account in 7.199 is very much akin
15 to the situation that's suggested as relevant in Intel,
16 isn't it?

17 A. Sorry, can you repeat the last part of the -- can I just
18 make an observation in passing? It's about a previous
19 answer. When I referred to the decision talking about
20 vigorous competition, I think I'm thinking of where it
21 talks about low pricing practices.

22 Q. I see.

23 A. Just to clarify. So it may be that it doesn't discuss,
24 use the term "vigorous competition", and that's what
25 I was thinking of.

1 Q. So we should read low pricing practice references in the
2 decision as synonymous with vigorous price competition;
3 that is my understanding?

4 A. Something along those lines, yes. So, sorry, could you
5 repeat the end of the question on 7.199?

6 Q. Yes. So I'm just -- I've run through 7.199, and you
7 highlight a series of factors there which are very much
8 factors that are present in the Intel case, and you then
9 say that's important because it means potential entry
10 into the bulk mail delivery market was vulnerable to
11 exclusionary conduct.

12 And you are saying that's a reason why an AEC or
13 price/cost test is neither necessary nor even
14 appropriate here, aren't you?

15 A. So let me orientate. So we have a reference to 7(b)
16 above, what does 7(b) say?

17 (Pause)

18 Q. What's essentially going on in this paragraph is
19 a summary of 7(b). (b), if you go back to 182, is the
20 conditions of competition in the bulk mail delivery
21 market and associated retail market for bulk mail. It
22 starts on red numbers 182, Mr Matthew.

23 A. 182?

24 Q. Yes.

25 (Pause)

1 So if you see it in the subheadings how the summary
2 has been made. Pick it up on 183:

3 "Royal Mail was ... and remains overwhelmingly
4 dominant ... structural advantages ... bulk mail
5 delivery market was [and is] characterised by high
6 barriers to entry ..."

7 It is also in long-term decline.

8 "Royal Mail was ... an unavoidable trading partner
9 for any access operator ..."

10 185. Then there are points then made about the
11 retail market and Ofcom's role which are not factors you
12 then pick up in 7.199.

13 So 7.199 is just highlighting what you purport to
14 have found as the conditions in the bulk mail market,
15 and it's then saying:

16 "Potential entry into the bulk mail delivery market
17 was vulnerable to exclusionary conduct."

18 So you are drawing that conclusion from your
19 analysis of the bulk mail market; that's correct, isn't
20 it?

21 A. Yes.

22 Q. And the point I'm making to you is that in cases where
23 an AEC was considered at the very least appropriate and
24 relevant, those factors or indeed factors more onerous
25 or potentially restrictive were found, and the market in

1 question was vulnerable to exclusionary conduct, and yet
2 that was no good reason for ignoring an AEC, was it?

3 A. So I think 7.199 -- and I haven't read all of 7(b), but
4 it may be that the key observation or a key observation
5 here was: firstly, you are vulnerable to exclusionary
6 conduct, but also it's saying in 7.199(b) conduct that
7 hinders the emergence of a less efficient scale entrant
8 is reasonably likely to limit a potential source of
9 competitive pressure, so maybe this is the theme that
10 where you have only got a less efficient entrant as your
11 possible source of competitive constraint, you need to
12 rethink whether the AEC standard is what works for you.

13 Q. Well, I understand that you want to tell this further
14 story, but let's just look at what's said here. You are
15 saying on the basis of those factors there is a finding
16 that potential entry into the bulk mail market was
17 vulnerable to exclusionary conduct and that's a reason
18 why you shouldn't carry out an AEC test and it's not
19 relevant in these circumstances, and I'm suggesting to
20 you that that does not stack up as a reason, Mr Matthew?

21 A. So are you asking me the question: all markets where
22 there is some risk of exclusionary conduct AECs are
23 never relevant? Is that what you are reading this as
24 suggesting?

25 Q. No.

1 A. I don't think it does suggest that. There were two
2 factors listed. One of them is talking about less
3 efficient entrants, and one argument, and it's something
4 that you think carefully about in the broader context of
5 the case, I agree, one argument is there are cases where
6 referring to an as-efficient competitor as being your
7 benchmark is problematic if that's the only -- if the
8 only competitor you are ever going to get is one that is
9 less efficient.

10 Q. Mr Matthew, this is (b), 7.199(b) you are referring to.

11 A. Correct.

12 Q. I'm asking you about 7.199(a) and I'm saying that those
13 conditions which give rise to a vulnerability to
14 exclusionary conduct do not give rise to a good reason
15 to ignore an AEC?

16 A. Is that what you are suggesting 7.199(a) says?

17 Q. Well, if you go down to (c), it says:

18 "An EEO/AEC test (comparing absolute levels of
19 prices ...) is not relevant in these circumstances."

20 So I find it difficult to read that paragraph
21 differently from it being Ofcom's finding that you
22 supervised that says: there is vulnerability to
23 exclusionary conduct, that is a key relevant reason why
24 an AEC is not relevant in these circumstances. I'm
25 saying that doesn't make sense.

- 1 A. As I say, I agree it's a relevant reason but it's not
2 the only reason given that (c) seems to be referring to,
3 because it's referring to two reasons above, one of
4 which is in this market there was one rival and it
5 wasn't able to match the position of Royal Mail for the
6 reasons we discussed at some length in the hot tub, in
7 particular that Royal Mail is selling into the market
8 off the back of the USO network, at incremental cost.
- 9 Q. We will come back to (b), but are you saying that
10 although (c) refers to both of these as reasons, in fact
11 it's just (b) that is critical here?
- 12 A. I think it's referring to both, but not just to (a).
- 13 Q. I see. You are making an assumption, then, that in
14 cases where these factors exist, high barriers to entry,
15 overwhelming dominance, economies of scale and scope and
16 unavoidability of trading, that in those other cases
17 where an AEC was used, there wasn't any hindering of the
18 emergence of a less efficient scale entrant?
- 19 A. Which cases are you referring to?
- 20 Q. Well, I'm thinking, for instance, just about Intel since
21 we have been talking about it. Are you making that
22 assumption, that all that Intel is concerned with is
23 as-efficient entry?
- 24 A. I'm not making an assumption about Intel. As I've said,
25 I know a bit about it, but it's not -- it's not the case

1 I've looked at closely.

2 Q. But if we see cases where the conduct in question could
3 hinder both an as-efficient competitor and
4 a less-efficient competitor, and an AEC is being used,
5 doesn't that make you question your reasoning in 7.199,
6 Mr Matthew?

7 A. I don't, it doesn't make me question the reasoning, and
8 I don't ... perhaps you could clarify why you think it
9 should.

10 Q. Well, because if the regulator, who has previously given
11 guidance, is carrying out an AEC analysis in relation to
12 pricing practices, which don't look like vigorous price
13 competition, on your definition, is doing so without
14 having specific regard as to whether or not it's just
15 an AEC who would be hindered but could also be
16 a less-efficient scale entrant being hindered, then in
17 those circumstances doesn't it suggest to you that
18 an AEC test is at least relevant in these circumstances?

19 A. That hasn't helped me. So what this seems to be saying
20 is it is one of the -- an example of the theme that says
21 when you have one rival or the only rivals you get are
22 going to be less efficient and therefore less efficient
23 competitors are the only possible source of competition,
24 you need to think about whether using an AEC test is the
25 right one. That's not saying that such cases wouldn't

1 exist where you would still use an AEC test, and that
2 would depend in my view on the broader context in which
3 you are thinking about it.

4 Q. So --

5 A. So to go to the obvious one, where you would still use
6 an AEC test, I think, except in very, very exceptional
7 cases, would be a predation case where you would say
8 "Well, you know, even if I believe that the only rival
9 can't survive, faced with the dominant firm pricing
10 below the rival's costs but still above the dominant
11 firm's own cost there needs to be a bright-line and we
12 should still use an AEC test". There may be a debate
13 about which cost standard you use within that and
14 whether you should be below the average avoidable cost
15 or go up to the average total cost standards, but that's
16 the sort of situation where you would still use an AEC
17 test, very -- in all likelihood.

18 So the existence of some cases -- I'm struggling to
19 think of a good case where ... well, the existence of
20 a case where you found there was only a less-efficient
21 competitor but an AEC test was used, doesn't mean that
22 you would do that in all cases, it would depend on the
23 other factors around that case.

24 Q. Let's try margin squeezes, shall we, Mr Matthew? You
25 have raised predation, but margin squeezes typically

1 I think you would accept -- abuse of dominance margin
2 squeeze cases, overwhelming dominance, large economies
3 of scale and scope, the nature of a margin squeeze is
4 that you are dealing with someone who is an unavoidable
5 trading partner for customers, and there would be a real
6 vulnerability to exclusionary conduct, wouldn't there,
7 in a margin squeeze?

8 A. In a margin squeeze case the mechanism to exclude is
9 plain, you can just squeeze them out completely if you
10 are unhindered if that's what you want to do.

11 I think the debate as to whether you actually want
12 to exclude is far less clear than in some other cases,
13 specifically this one, and as you will be familiar there
14 is a long standing economic debate about, when do firms
15 actually wish to exclude competitors from downstream
16 markets, which are separate from the ones where they
17 themselves are dominant, and that's the Chicago School
18 argument that says well, if you have your one monopoly
19 profit in the upstream monopoly, why do you actually
20 want to keep more efficient people out downstream?

21 There has been endless literature and people have come
22 up with reasons why you might want to be excluding
23 downstream, but it's not self-evident.

24 Q. Just to be clear, are you saying there that it's intent
25 that matters?

1 A. No, more generally, just as an observation about the
2 market context, and this won't be true in all cases, but
3 quite often in margin squeeze cases the general -- the
4 risk that you are going to find that the dominant firm,
5 leaving aside its ability to raise everybody else's
6 wholesale price, but in all other respects has
7 particularly strong competitive advantages is going to
8 be, not in all cases, but in a lot of cases going to be
9 far less than the situation where you are thinking about
10 the core monopoly, facing entry into the core monopoly.

11 So often, yes, you know, you will have your core
12 facility and then you have a retail operation, but other
13 people will have their own retail operations that don't
14 necessarily lose out through economies of scale and
15 scope to any great degree. So a lot of margin squeeze
16 cases will fall into that category.

17 Q. Are you saying that intent is the critical factor here,
18 then, whether or not you can identify whether or not one
19 would have intent to exclude and foreclose?

20 A. I think intent can -- it plainly is relevant. I think
21 the role it plays depends on the broader context of the
22 case and the other factors.

23 Q. Let's just go back to that margin squeeze example,
24 though. You have got a situation where there is
25 evidently real vulnerability to the market being subject

1 to exclusionary conduct and the conduct in question
2 could be specifically targeted at deterring or
3 preventing entry, and I think as you accept, AEC tests
4 are appropriate in those circumstances, aren't they?

5 A. Well, as I explained, AEC tests are commonly used in
6 margin squeeze cases and --

7 Q. And that would apply -- I am sorry.

8 A. There is scope for exceptions to that, I understand,
9 legally. But the point I was making is, and this is
10 a policy perspective as to what test you would want to
11 use, is that in margin squeeze using an AEC makes quite
12 a lot of sense to me as a general rule because the
13 balance of getting it right and wrong suggests it's
14 a good one to draw, it's a nice way to be able to set
15 a set of rules that everybody can be clear about, about
16 what dominant firms that are vertically integrated can
17 do by way of raising their wholesale price in
18 circumstances where, you know, chilling raising
19 wholesale prices has potentially negative effects here,
20 as you potentially are undermining their ability to
21 recover their investments, et cetera and rightly, people
22 would often think, well, if that's your concern, you
23 need to be careful you are not using a margin squeeze
24 case as a basically an excessive pricing case by the
25 back door, you should go through the excessive pricing

1 standard and --

2 Q. I understand you want to distinguish margin squeeze
3 cases, Mr Matthew. I'm asking you very simple questions
4 here.

5 You have a situation in a margin squeeze case where
6 all of the criteria set out in 7.199 are met, and it is
7 clear that in those circumstances, as you have said,
8 an AEC test is appropriate, haven't you?

9 A. So can I just finish? Because I will cut it short,
10 because I was going on too long, and I will try and keep
11 it short.

12 The observation was in margin squeeze cases in
13 general AECs provide a nice bright-line and there are
14 good reasons economically why that should be
15 a bright-line. That doesn't mean that that bright-line
16 is perfect in all circumstances. No bright-line ever
17 is. And the fact that you will be able to find some
18 margin squeeze cases where there are potentially
19 foreclosure effects as an economist would think about
20 it, even while an AEC is passed, doesn't read across to
21 any more general observation that says, well, because
22 some margin squeezes you might have thought using an AEC
23 doesn't give you a good answer means that that has
24 implications for all other cases as well, because when
25 you are into the sorts of practices we're talking about

1 in this case, we don't have that same presumption that
2 an AEC bright-line has obviously the right determinative
3 bright-line to draw as we do for the margin squeeze.

4 Q. You have that presumption, Mr Matthew, and you have
5 distinguished margin squeeze cases, but the point I'm
6 putting to you is a much, much more simple one which is
7 that in margin squeeze cases you have all of the factors
8 that are identified in 7.199, high barriers to entry,
9 overwhelming dominance, economies of scale and scope,
10 unavoidable trading partner status, you can have
11 targeting as well, and in those circumstances AEC tests
12 are clearly appropriate, so those criteria are not
13 a sufficient basis for saying that AEC tests are
14 irrelevant, are they?

15 A. So if you tell me there is a margin squeeze case where
16 in the retail segment we're talking about all of these
17 features apply, so there are -- it is the case that the
18 retail segment is heavily prone to exclusion, it is the
19 case that the retail segment, the dominant firm has
20 unmatchable advantages in the retail segment, and you
21 tell me there is intent, I suspect you would be in
22 a situation where you would be asking: is this
23 an exception to the standard rule in margin squeeze
24 cases? And should we be thinking of the TeliaSonera
25 type exceptions that maybe we do need to think again

- 1 about whether the AEC is going to give us the right
2 answer in this specific case.
- 3 Q. Well, I think the notion of TeliaSonera exceptions is
4 self-contentious, Mr Matthews.
- 5 A. -- what you don't find, so these sort of arrangements
6 often are not found in marginal squeeze cases. Often in
7 fact not --
- 8 Q. Mr Matthew, you have moved on to the retail market here.
9 I was asking you about whether or not you have these
10 factors in a margin squeeze case and you apply an AEC.
11 The answer is yes, isn't it?
- 12 A. In margin squeeze cases it is the retail market that the
13 concern is about. So you do have to look at the retail
14 market.
- 15 Q. Let me just move on in relation to margin squeeze. In
16 relation to margin squeeze, I think you have already
17 accepted that you could have a margin squeeze simply
18 based on the wholesale price going up; that's correct,
19 isn't it?
- 20 A. That's correct.
- 21 Q. And that wouldn't be a low pricing practice, would it?
- 22 A. It's ... well, as I said, I think it would be
23 potentially an excessive pricing practice that we have
24 a different set of rules for when the objective of
25 competition law is to prevent excessive pricing and that

1 the point I was making is I understand -- you're right,
2 of course, if the wholesale price goes up, that raises
3 the costs of rival retailers --

4 Q. So it's not a low pricing practice; correct?

5 A. Well, you need to be clear about what we mean by low
6 pricing practice. You mean low pricing practice in the
7 sense that I talk about it in my report, then I don't
8 think -- I think margin squeeze concerns are concerns
9 with a low pricing practice even though the squeeze
10 itself obviously can arise from raising the wholesale
11 price.

12 Q. So, just so that we understand, on your definition,
13 a low pricing practice does not involve or need not
14 involve lowering prices; is that correct?

15 A. (Pause). A low pricing -- sorry, can you say it again?
16 A low pricing practice --

17 Q. Yes, on your definition doesn't necessarily involve
18 lowering prices?

19 A. Your observation is: because margin squeeze involves,
20 could involve a higher wholesale price, it doesn't
21 involve lowering prices, no, but it does involve
22 lowering the retail margin in the market segment that
23 the potentially foreclosing conduct is concerned with.

24 Q. Okay, I'm just going to ask it once more, Mr Matthew:
25 your definition of low pricing practice, does it require

- 1 a lowering of prices?
- 2 A. In the case of margin squeeze, no, it requires
3 a lowering of the retail margin in a margin squeeze
4 context.
- 5 Q. Just to be clear, that wholesale price going up would
6 raise costs of entry, wouldn't it?
- 7 A. A lowering of the retail margin raises -- reduces the
8 profits of entry, and I agree that since raising the
9 wholesale price reduces the margin, then yes, it makes
10 entry more difficult if all else equal.
- 11 Q. So it does reduce the likelihood of entry but it's not
12 low pricing and at one point during your answers you
13 seemed to suggest that you should treat it as
14 an excessive pricing case, but you are not suggesting
15 that once a wholesale price is going up, you shift out
16 of margin squeeze analysis into excessive pricing, do
17 you?
- 18 A. I think if your concern is simply that you have a higher
19 price, which I think -- I understood was the point you
20 were putting to me, that a margin squeeze arises from
21 some higher price, I was pointing out that what you
22 don't want to do is say "Well, yes, I've got a higher
23 price" and take the overly simplistic view that because
24 that higher price raises the costs of retail firms, that
25 that automatically takes it into a different standard.

1 I was observing that people may raise the wholesale
2 price for a whole variety of reasons and in general
3 competition law doesn't stop them from doing so.

4 Q. So I just want to be clear about where we are with your
5 low pricing practice test. Your low pricing practice
6 test says: if this is a low pricing practice, then
7 an AEC test will be relevant, but if it's not a low
8 pricing practice, we can ignore AEC entirely; is that
9 correct?

10 A. If it's a low pricing practice and low -- lowering the
11 retail margin in a margin squeeze case is such
12 a practice, I agree, then yes, AECs are going to -- are
13 the natural place to start.

14 Q. If a conditional pricing practice didn't involve
15 lowering price -- sorry, if a low pricing practice
16 didn't involve lowering price, how are we supposed to
17 tell what a low pricing practice is, Mr Matthew?

18 A. For conditional pricing practices?

19 Q. Sorry, either in conditional pricing practices or in
20 margin squeeze or in other types of pricing conduct.

21 A. Well, in the case of margin squeeze you tell by looking
22 at whether conducting an AEC test is the first port of
23 call because you're concerned with the retail margin
24 being too low.

25 In the case of conditional pricing practices,

1 I agree it will often be hard to tell and as I said
2 earlier, in some cases it will be pretty plain it is
3 merely a vehicle for setting non-linear prices which is
4 meeting competition.

5 In other cases it will be reasonably plain that it's
6 the opposite and it's a penalty aimed at raising the
7 rivals' costs without actually having to compete.

8 In other cases it will be unclear, and when it's
9 unclear, I can understand that one might have more
10 reference to an AEC test, along with other factors.

11 I mean, as I said in the hot tub, I think when you
12 are in the category of practices that typically have
13 arisen in some of the conditional pricing cases,
14 I really don't want to claim I'm familiar with all of
15 those in depth, but where you are dealing with
16 a situation where we are talking about making the terms
17 of supply of a monopoly product conditional on what
18 customers or competitors do in a more competitive
19 segment, you should be careful, and when it appears to
20 be raising the costs of them competing in that segment
21 I do think you need to be careful, and it doesn't seem
22 right to me that you would treat the AEC as
23 a bright-line determinative test in that context.

24 Q. Let me just be clear, Mr Matthew. These questions at
25 this stage are not about bright-lines being

1 of determinative nature. I was asking about whether or
2 not the AEC was relevant.

3 Just going back to your answer in relation to
4 conditional pricing practices, as I understand it, you
5 are saying that there are a range of conditional pricing
6 cases, you give them some sort of general assessment at
7 the outset and work out what sort of conditional pricing
8 practice they are before you decide whether or not you
9 should carry out an AEC analysis. Am I summarising
10 correctly?

11 A. I think I'm saying that there are conditional pricing
12 cases where you can reach a view that it's
13 anticompetitive foreclosure, and it's achieved through
14 competition that is not price -- low price competition,
15 and in which you can say "I don't need to do an AEC
16 analysis in this context to reach a foreclosure
17 finding", and therefore the outcome of an AEC test is
18 just not relevant because it wouldn't give you
19 a different answer whether or not it's passed.

20 Q. I would suggest to you, Mr Matthew, that this
21 illustrates why the distinction that you are seeking to
22 draw here is not in any way principled or fair and
23 operable in relation to an ex post competition provision
24 like Article 102; is that correct?

25 A. I'm not sure what you mean by fair. Operable, I agree

1 it's tricky, I think we are in a situation however where
2 you are dealing with practices that potentially anyway
3 can have a large foreclosing effect, they can achieve it
4 without competing on price, they can achieve it often
5 with low costs to the firm deploying them, and in that
6 situation it seems to me that, you know, one version of
7 operable is the old sort of form based approach where
8 you just say they're per se illegal, that's operable.
9 As an economist, I don't think it's sensible but it's
10 operable.

11 For my perspective, you do reach a point where
12 drawing very, very clear lines as to precisely how
13 you -- far you can go in those cases, and these are the
14 cases, and I'm thinking of the cases where you are able
15 to do this leverage from contestable to non-contestable,
16 it's not any conditional pricing practice in the broader
17 economy, even by dominant firms, you should accept the
18 potential that you will be able to identify some cases
19 as pretty plainly intentional and effective foreclosure,
20 others which pretty plainly are a version of competition
21 on the merits to be determined, checked with an AEC,
22 others where the boundary may be difficult, and those
23 you usually -- it's not my place to write policy, but
24 I thought you have things like rebuttable presumptions
25 that demand different standards and weight of evidence,

1 depending on which side of the line you would fall
2 and --

3 Q. Aren't you in danger, Mr Matthew, of putting regulators
4 in the position they use your test of becoming modern
5 day equivalent of the Witchfinder General, that you can
6 smell a problem in competition law and that that is
7 sufficient for these purposes?

8 A. No. I don't see that at all.

9 MR BEARD: Is it a convenient moment?

10 THE CHAIRMAN: On that note of constructive ambiguity, we
11 might pause for ten minutes.

12 (11.45 am)

13 (A short break)

14 (11.55 am)

15 MR BEARD: Before I move on to a new topic, I just wanted to
16 pick up something from the exchanges just before the
17 break.

18 I think you referred to distinguishing margin
19 squeeze cases, in part on the basis that the consequence
20 of the margin squeeze, even if it's a wholesale price
21 rise, is that the retail margin is lower. That's
22 I think what you said. Is that correct?

23 A. Yes, that's the concern.

24 Q. Yes. Just to be clear, in this case, this is a case
25 where you end up with a lower retail margin, don't you?

1 A. (Pause). I need to understand that better. So the
2 retail margin ... it is true that if you face a higher
3 access price then the retail margin would be lower, yes.

4 Q. So if your criteria for treating margin squeeze cases on
5 your approach as low pricing practices, why wouldn't you
6 treat this as a low pricing practice or within your
7 category of low pricing practices if retail margin being
8 lower is a key determinant for margin squeeze?

9 A. Okay, I understand. So this case could also have been
10 a margin squeeze. I mean, given that it does involve
11 a wholesale sale price and a retail price, it is
12 possible that there could have been a margin squeeze as
13 well. It's just that is not the focus of the concern.
14 The focus of the concern is the conditionality
15 introduced by the price differential.

16 It is possible that one or both of the price,
17 wholesale price with or without the price differential,
18 one or both of them may have failed a margin squeeze
19 test also, that just wasn't the focus of the concern
20 though.

21 Q. But when we're talking about shifting pricing, if and
22 insofar as differential pricing did reduce a retail
23 margin, then you would treat it as being something that
24 was a margin squeeze and therefore should be subject to
25 AEC analysis; correct?

- 1 A. If the concern was solely you have a wholesale price and
2 a retail price and it's not allowing a margin for people
3 to compete, then that would be a margin squeeze
4 objection.
- 5 Q. Can I just go to how your test works in relation to
6 discrimination? Now, we heard from Mr Matthew(sic) how
7 at least initially when he put in his independent expert
8 report to Ofcom he characterised the pricing as being
9 a discount on NPP1, that was how he looked at it
10 initially. You remember that?
- 11 A. You said "Mr Matthew", I think you mean --
- 12 Q. I am sorry, I meant Mr Parker, I apologise, Mr Matthew.
13 No offence is intended to either of you. I do mean
14 Mr Parker. He, in relation to his initial independent
15 expert report, characterised these matters as
16 a discount. You remember hearing that?
- 17 A. I think I remember hearing it, yes.
- 18 Q. Then you accept that a relative price difference,
19 I think, can be seen as a lower price to one group or
20 a higher price to another group; that is correct, isn't
21 it?
- 22 A. If it was just a relative price difference, yes.
- 23 Q. So a relative price difference can be seen in those
24 circumstances as a low pricing practice, can't it?
- 25 A. Well, a relative pricing difference doesn't tell you

1 anything about whether it's high or low.

2 Q. It doesn't --

3 A. It is relative.

4 Q. Is that because you would need to carry out the

5 counterfactual analysis as to what the prices would be

6 absent the conduct in question?

7 A. Yes, you could go down that route and attempt that.

8 I think in this case there is evidence on what's going

9 on. It's ... that's laid out in the decision.

10 Q. Normally you would suggest that you do need to do

11 a counterfactual analysis in order to work out whether

12 or not some things are a discount or a raise; correct?

13 A. Normally, I'm not sure what "normal" would be here.

14 I think when you have evidence that it's a price

15 penalty, a surcharge, then you don't need to think about

16 the counterfactual.

17 Q. I see. Could we go to the decision, Mr Matthew,

18 page 39, please. Sorry, it's 39 of the external

19 numbering.

20 A. It's the table with the ...

21 Q. Table 3.1, page 39, the red numbering, Mr Matthew,

22 sorry.

23 A. I have it.

24 Q. So this is a comparison of NPP1 and APP2, ZPP3 prices

25 for access services 2013 to 2014. So this is the table

1 of prices prior to any changes being made under the
2 CCNs. You recognise that?

3 A. Yes, that's what the title says.

4 Q. Yes?

5 A. Yes.

6 Q. I'm just taking the top line for reference, 20 CBC
7 letters, 100 grammes, 19.47p and the same for APP2.
8 Okay?

9 A. So this is before the CCNs; is that right?

10 Q. It's before the CCNs, of course after the CCNs you still
11 do not have changes in prices.

12 A. Yes.

13 Q. The CCNs, if one turns over the page, were intended to
14 make changes to the pricing along the following lines,
15 you see that in the table, comparison of NPP1 and APP2
16 for key access services as specified in CCN 002?

17 A. Yes.

18 Q. So if you look at 70 CBC letters, what you see there is
19 that the NPP1 for 2014/2015 would not be 19.47p, it
20 would be 20.07p.

21 A. Yes, I see --

22 Q. And then the intention was that the APP2 price would be
23 20.31p. You see that?

24 A. Yes.

25 Q. Now, we know of course that the CCNs were never applied.

1 Could you tell me, absent the CCNs, would the price of
2 NPP1 have been 20.31p or 20.07p, without the price
3 differential element?

4 A. I think on the evidence that I'm aware of it is likely
5 that the NPP1 price was the profit maximising price, and
6 that the differential was a surcharge on top of it.

7 Q. So did you do an analysis of whether the NPP1 was the
8 profit maximising price and APP2 was a surcharge,
9 Mr Matthew?

10 A. Well, I think the -- okay, so the features that I think
11 are relevant here were firstly the design of the CCNs,
12 so the observation that what Royal Mail was trying to do
13 was avoid revenue dilution, which I take to mean
14 maintain its revenue which, if it had cut the price, it
15 would have diluted, and the way to achieve that was to
16 put a surcharge on, and linked to that is, I think,
17 another piece that is relevant to me, is the view that
18 actually probably the expectation was that Whistl
19 wouldn't actually go for its entry, it would switch back
20 to NPP1, so it would come back to this price point. So
21 it was never expecting the APP2 to actually apply in
22 practice.

23 Q. The short answer is, Mr Matthew, you don't know, do you?

24 A. Well, the evidence suggests to me that they were selling
25 the price that they thought would make the most money,

1 maximise their revenue, and that the APP2 was
2 a surcharge on top of that which they probably thought
3 would never actually apply in practice because it
4 wouldn't be taken up.

5 Q. Where is the analysis of this, Mr Matthew?

6 A. Well, I think the salient features I've just described
7 are in various places in the decision.

8 Q. But there is no analysis of the first assertion you made
9 about which was the profit maximising price, is there?

10 A. There is extensive reference to the objective of
11 avoiding revenue dilution and I think there are places
12 in the decision which do talk about lack of direct
13 benefit to consumers, et cetera, but I'm afraid I can't
14 go straight to those references because I don't hold
15 them in my head.

16 Q. You didn't carry out the analysis and you don't know is
17 the position, Mr Matthew.

18 Let's just look at this significant revenue dilution
19 point. You raise it in your witness statement, it's
20 referred to in the decision, if we go to 7.196.

21 You say, it says in 7.196:

22 "... as we have outlined above, the price
23 differential is not a case of 'pure' primary line or
24 first degree discrimination ..."

25 Which is a topic discussed in the hot tub:

1 "Further and in any event, the issue in this case is
2 not whether MPP1 or APP2 prices are too low; indeed
3 Royal Mail expressly rejected any package of pricing
4 that involved 'significant revenue dilution'. Neither
5 is this a case of potential example of margin squeeze",
6 so you say.

7 But are you saying that that indication there tells
8 you whether or not 20.07p or 20.31p is the profit
9 maximising price, Mr Matthew?

10 A. Well, I think it tells you that Royal Mail was trying to
11 set prices to make money and was imposing a surcharge on
12 top of that.

13 Q. Well, let's have a look. The footnote there says "See
14 paragraph 4.115", so we have to go backwards to 4.115
15 here, which is on page 86.

16 There is a document here entitled "Royal Mail's
17 commercial response", and you can see from the footnote
18 that it's actually a document of 11 December 2013. Just
19 for the tribunal's notes, it's in bundle C4B, at tab 62.

20 Just let's read what it says there:

21 "We have investigated [so this is we, Royal Mail]
22 a number of price responses. Given the need for the USO
23 to be sustainable and affordable and earn a commercial
24 rate of return, any response that involves significant
25 revenue dilution, eg an across the board access price

1 cut, is not realistic."

2 Then you quote:

3 "There is no price difference between the two ... we
4 are proposing to introduce a price differential
5 reflecting a cost benefit to Royal Mail. Under NPP1 we
6 received detailed customer forecasts at local level
7 which allow us to plan better. In addition we are
8 proposing to increase the zonal price differentials."

9 So here we have the source of that piece of evidence
10 you rely on, Mr Matthew, and what Royal Mail was
11 rejecting was an across the board price cut.

12 Now, we know that in fact there were price rises,
13 quite apart from the price differential, don't we,
14 Mr Matthew, proposed in the CCNs?

15 A. So, yes, there was a price rise.

16 Q. So how can you possibly take this piece of information
17 there and suggest that you know what the profit
18 maximising price for NPP1 was?

19 A. I think this is suggestive of what I said, it's
20 suggesting that what Royal Mail was doing here was not
21 cutting its prices but putting in place the prices it
22 thought would -- okay, was it profit maximising?
23 I haven't analysed what precisely the profit maximising
24 price was. That's always a difficult thing. But it was
25 basically setting a price that it would get it the

1 revenue it wanted and didn't want to meet the threat of
2 entry by cutting them, and therefore it adopted the
3 surcharge approach instead.

4 Q. No, Mr Matthew, you have presumed it's a surcharge, you
5 don't know whether it's a discount or a surcharge
6 because you haven't done the analysis, do you?

7 A. I think there is evidence that suggests it's
8 a surcharge.

9 Q. Mr Matthew, what this evidence suggests is that
10 Royal Mail had suggested that there would not be
11 an across the board price cut; that is in fact what
12 happened, wasn't it, Mr Matthew? If the CCNs, leave
13 aside the price differential, had been put in place,
14 that is what would have happened, isn't it?

15 A. Sorry, what would have happened?

16 Q. There would have been a price rise, not a price cut.

17 A. So ... so I agree with you, the CCNs are not introducing
18 a price cut.

19 Q. So the CCNs were not introducing a price cut and that
20 was what was being rejected here, and it doesn't tell
21 you about the position in relation to the price
22 differential, does it?

23 A. Well, the reference is to revenue dilution, so they're
24 trying to avoid revenue dilution, eg by -- through
25 cutting in their price, and what they've done is use the

1 mechanism that you get with the price differential to
2 say: well, if you stop taking from us, we will increase
3 your price, we will put in place a surcharge. I think
4 that's a reasonable reading of what's here.

5 Q. Well, let's just look at that. The question that we've
6 got is that the prices were going to be higher in any
7 event, and the question you had to ask was how much
8 higher they would have been without the price
9 differential; that's correct, isn't it?

10 A. I don't think you need to -- sorry, I don't think you
11 need to ask that question. I think the relevant point
12 here is that the intention behind the pricing strategy
13 was not to lose revenue. Which to me takes you, given
14 the mechanisms available using conditional pricing
15 arrangements, to the use of a surcharge.

16 Q. Now, Mr Matthew, an intention not to lose revenue could
17 be met by raising all your prices and offering a limited
18 discount, can't it?

19 A. Well, then it wouldn't be a discount, it would be
20 raising all your prices relative to what they otherwise
21 would have been.

22 Q. But we know that prices were going to be raised, don't
23 we, Mr Matthew, absent the price differential?

24 A. So price -- Royal Mail was seeking to put prices up
25 anyway, I agree.

1 Q. So you don't know whether or not the counterfactual
2 price for NPP1 would have been 20.07p or 20.31p or some
3 other price, do you, Mr Matthew?

4 A. I think the reading of trying to avoid a revenue
5 dilution tells you that it is not likely that they were
6 offering a discount, they were trying to set the price
7 that would give them the revenue and then set
8 a surcharge to those who deviated, and I think when they
9 took away the ... when they -- if you say the price
10 differential was removed, did they -- do they then cut
11 the price?

12 Q. Mr Matthew, the CCNs were suspended, as you know, all
13 aspects of them.

14 A. Right, so when there was no price differential, did they
15 raise the price?

16 Q. You don't know, do you, Mr Matthew?

17 A. Well, I'm just observing on the facts I don't think they
18 did.

19 Q. Yes, but Mr Matthew, this is precisely the sort of
20 enquiry that if you weren't simply presuming that you
21 had decided on intent and treated this as a penalty or
22 surcharge, this is the sort of enquiry you would have
23 carried out, isn't it?

24 A. I think the evidence here indicates what I've said, what
25 they seem to have been doing is setting a price they

1 thought would make them money, they didn't want to cut
2 the price and therefore lose revenue to meet competition
3 so they used the price of surcharge mechanism instead.

4 I think that seems to be a fair reading of the evidence.

5 Q. We may differ there, Mr Matthew.

6 Now, just going back to your low pricing practice
7 test, if something isn't a low pricing practice, my
8 understanding is that you say that you don't need to do
9 an AEC, you carry out I think what you have referred to
10 as an "in the round assessment"; is that right?

11 A. I think you might still do an AEC, depending on the
12 broader factor. What I was suggesting is you don't do
13 an AEC in all cases and use it as a safe harbour in the
14 way that was suggested as we should have done here.

15 Q. But if an AEC assessment is done, you are saying that in
16 many low pricing practice cases, it would be relevant
17 information; is that correct?

18 A. Well, if it's low pricing you generally would go to the
19 AECs --

20 Q. I'm so sorry, I misspoke, I meant the non-low pricing
21 practice. That was a confusing question, let me ask it
22 again.

23 If an AEC assessment is done, are you saying that in
24 many non-low pricing practice cases, it would be
25 relevant information; is that correct?

- 1 A. If it's clear it's not a low pricing case, then the
2 relevance of the AEC is not clear to me.
- 3 Q. So if it's clear it's not a low pricing case, then you
4 think you don't need to take into account the AEC, is
5 that what you are saying?
- 6 A. If you have reached on the basis of your evidence of the
7 broader market and the practice itself and the intention
8 that you feel this is not vigorous competition, then
9 an AEC merely tells you whether or not an equally
10 efficient firm would be able to withstand whatever
11 methods are being used against the rival.
- 12 THE CHAIRMAN: I must confess I'm getting a little lost in
13 the double negatives, if not the triple.
- 14 MR BEARD: I will try and move away from them.
- 15 A. So it is my view that when you reach those cases you
16 don't -- you know, what AEC as a safe harbour becomes
17 a -- is no longer a useful reference point. Evidence as
18 to margins and how they may affect the incentive effects
19 of the conduct may still be useful and you can use that
20 evidence potentially. I know that Mr Dryden suggested
21 in the hot tub that he had done some analysis that said
22 "I cannot only tell you whether a price/cost margin is
23 sufficient to allow a firm, a rival to survive", I can
24 also tell you from my analysis which one is the most
25 profitable, so rolling out to different levels he found

1 it's always profitable to actually roll out to 100% of
2 the UK. But that's evidence as to effects, and there is
3 for me no particular reason why you would go to an AEC
4 concept for that purpose, and it would seem to us, as
5 I suggested, that it wasn't useful, doesn't -- it wasn't
6 a useful evidence as to what the likely effect of the
7 conduct would be in the real world.

8 Q. Can I just do a comparison of low pricing practice and
9 non-low pricing practice? So a low pricing practice,
10 that could lead to deterrence or suspension or non-entry
11 into a market; that's correct, isn't it?

12 A. Yes, along with low pricing practices, they can also
13 have those effects too.

14 Q. In this case, you have said that you presume that there
15 is consumer harm from a loss of competition in bulk
16 mail; that's correct, isn't it, as well?

17 A. Yes, from a general perspective, my view is competition
18 and the competitive process is desirable.

19 Q. But when you say --

20 A. And --

21 Q. I'm so sorry, I cut across you.

22 A. And therefore if you see a practice that is liable to
23 very substantially reduce competition going forward, you
24 can infer from that loss of competition as liable to
25 give adverse effects to consumers, and I think that's

1 the general presumption of most competition policy
2 broadly defined. That's not to say that one can't come
3 up with cases where it's possible that competition
4 actually isn't a good thing, and I think my point is for
5 that you need a pretty good reason why you think
6 competition is actively undesirable. And I didn't think
7 it was necessary for -- to go further than saying: well,
8 I think there is significant damage to the competitive
9 process here and go on to a sort of quantified attempt
10 to evaluate consumer welfare.

11 Q. So what you are talking about here is a possibility of
12 a competitor exiting or not entering the market, but in
13 relation to this low pricing practice you don't have
14 a problem with the exit of a less-efficient competitor
15 there, do you?

16 A. If you are in a situation where the dominant firm has
17 reacted to entry cutting its price, competed in what
18 I would usually think of as a typical way, and the
19 result is the competitor can't stand it, then an exit,
20 that's for me the process of competition working.

21 Q. So what you are explaining is sort of general intuition
22 that fewer competitors reduce consumer welfare but in
23 your low pricing practice cases the lower prices
24 increase consumer welfare and create some sort of
25 balance; is that right?

1 A. Yes, I think you have to think about what do you mean by
2 competition and competition from the dominant firm, the
3 main supplier to the market, is plainly an important
4 part of the competitive process working and you don't
5 want to get in the way of that inappropriately.

6 Q. So you are weighing up consumer benefits and detriments,
7 and you recognise that you use an AECT test as a sort of
8 shortcut or proxy to carrying out that analysis; is that
9 right?

10 A. So for -- yes, so when you are thinking about the
11 dominant firm's cut its price, how do you tell when that
12 gets to becoming anticompetitive foreclosure, you have
13 to be very careful, you want dominant firms to cut their
14 price, and the AEC test provides an important safe
15 harbour in those cases.

16 Q. I think you have also said that you use AEC as
17 a reasonable proxy based on dominant undertaking's costs
18 so that the dominant undertaking can carry out
19 self-assessment, there is a measure of predictability;
20 correct?

21 A. I agree, for a broad range of those types of practices
22 it's important not only for the dominant firm but also
23 other dominant firms who may not be the subject of an
24 immediate investigation but are thinking, well, what am
25 I allowed to do? Clearly they need to have good

1 guidance as to whether setting low prices is problematic
2 and so on.

3 Q. Just to be clear, embedded in the AECT proxy then is the
4 willingness to trade off productive efficiency of
5 dominant company pricing down to costs with allocative
6 and dynamic effects as well; is that right?

7 A. As to whether the precise specification of the AECT
8 achieves those balances that is something one needs to
9 think about. The main thing is to have a reasonably
10 clear direction, and I think essentially to say,
11 you know, it's important that dominant firms are able to
12 compete as freely as we can say is reasonable, and as
13 you will be aware, so, for example, different
14 jurisdiction, may take different views about how
15 strongly those thresholds should be drawn. Typically,
16 I haven't looked at the US rules for a long time, but US
17 rules on predation used to be viewed as somewhat tougher
18 than the European ones but they are serving
19 a similar-ish purpose in the sense of setting
20 a bright-line as a possible difference into what balance
21 you are drawing between the various positives and
22 negatives.

23 Q. But in carrying out that trade-off, you are recognising
24 that if a dominant undertaking does price down to costs,
25 then you are potentially eliminating all less efficient

1 competitors; that's recognised, isn't it?

2 A. Yes, so if you allow the dominant company to do that you
3 are accepting the possibility -- and this is where you
4 have no possibility of any exceptions, no matter what,
5 let's take that as the harsh version, the hardest
6 version.

7 Q. Understood.

8 A. Then yes, you are saying it's important to allow
9 dominant firms to price down to their costs, if I'm in
10 America that means marginal costs, as part of telling
11 them you would have freedom to compete very freely. The
12 competition rules aren't there to stop you, and that has
13 with it the possibility that certainly less-efficient
14 competitors can't survive. If it's a marginal cost
15 standard, even an as-efficient competitor may not be
16 able to survive. And you accept, if there are no
17 possibility of no exceptions, that those things are
18 a good trade-off with the broader benefit of making it
19 clear dominant firms are allowed to compete vigorously.

20 Q. So in the low pricing practice case, you are saying that
21 you have got an intuition that loss of a competitor can
22 harm consumers, but you are not assuming that the loss
23 of any competitor will harm consumers; that's correct,
24 isn't it?

25 A. I think you're assuming that given the practices

1 concerned you need a clear rule and that's probably the
2 priority thing for those types of cases, and you are
3 accepting the possibility in some cases, real predation,
4 for example, can happen, can lead to damage to the
5 competitive process and that consumers can be harmed,
6 but you accept that the possibility of a small number of
7 cases like that is a good trade-off with giving clarity
8 to dominant firms that they can compete generally --

9 Q. I understand the trade-off point.

10 A. -- and it seems to be a reasonable judgement to make.

11 Q. That wasn't quite the question. What I'm asking you is
12 that in a low pricing practice case you don't presume
13 that the loss of any competitor will harm consumers, do
14 you, because there is a possibility that consumer
15 welfare could increase despite the loss of competition;
16 you accept that, don't you?

17 A. Yes, because the dominant firm itself by competing
18 aggressively that prompts the exit is delivering
19 benefits to consumers.

20 Q. But actually the same possibility exists in this case,
21 because entry, whether efficient or inefficient, takes
22 volumes out of the Royal Mail network and loses for
23 Royal Mail contribution to its common costs from those
24 volumes that are diverted away, doesn't it?

25 A. That's raising a different point. That's saying while

1 I could probably presume in the activity we're concerned
2 with, competition as long as it's achieved without
3 constraining the ability of the dominant firm to compete
4 aggressively, is desirable, however, because we have
5 this for a multiproducts firm using a single network,
6 the possibility arises that the very process of
7 competition occurring leads to a dilution of margin
8 earned on one product that may undermine the ability of
9 the network to recover its costs overall, and therefore
10 while generally competition is good, there may be some
11 cases where it could result in negatives, and as
12 discussed at some length in the hot tub and elsewhere
13 that's a matter that is very much to the fore of Ofcom's
14 evaluation of its powers in relation to this area.

15 Q. What you are essentially saying there, as I understand
16 it, is that you would accept that there would be
17 circumstances where Royal Mail may have to increase its
18 retail prices in order to hit its break-even threshold
19 as a multiproduct firm and that that, on your analysis,
20 could reduce consumer welfare; is that correct?

21 A. No, well, I think that's some steps beyond. I think all
22 I was saying is the point that's been made many times,
23 that if you lose revenue on one product and you find you
24 can't then support the overall network, then you could
25 undermine the USO's services --

- 1 Q. But --
- 2 A. -- and that is -- obviously one of Ofcom's objectives is
3 for that not to happen.
- 4 Q. Step away from the USO for the moment, Mr Matthew. You
5 are talking about a multiproduct firm, it has
6 a break-even threshold, I think you accept that that is
7 one of the criteria that it has to take into account; is
8 that correct?
- 9 A. The dominant firm will assume it has some costs to be
10 recovered from both markets.
- 11 Q. So if you have inefficient entry, there will be a loss
12 of contribution to its common costs from volumes that
13 are competed away from it; is that correct?
- 14 A. If you have any entry, that will be the effect, whether
15 the entry is efficient or inefficient is not
16 determinative of the answer, that's why I make the
17 points that what we're talking about here is something
18 slightly more fundamental, which is: is it actually
19 desirable to have competition, even if it's by
20 an as-efficient competitor in that product.
- 21 Q. Well, except that in relation to a less efficient
22 entrant, the problem is greater, isn't it, because in
23 relation to the services at issue, in the long run the
24 less-efficient competitor entrant is never going to
25 displace the incumbent, is it, in the area where it

1 entered?

2 A. So we need to be thinking about whether we are talking
3 about as efficient in relation to bulk mail or
4 as-efficient across the whole network. So if you are
5 saying -- so in relation to bulk mail there is
6 a possibility arises that someone, a rival could be as
7 efficient as Royal Mail, so it's highly unlikely to be,
8 and as we discussed in the hot tub, but one could
9 imagine Royal Mail's argued that Whistl has lots of cost
10 advantages of its own, so let's imagine those were
11 sufficient to outweigh the disadvantages from having
12 only a, you know, just one product, not the entire
13 network.

14 In that situation, you could have entry by a firm
15 that was as efficient in bulk mail and it would win
16 business from Royal Mail more effectively than one that
17 was inefficient in bulk mail and would therefore create
18 damage in the way you suggest.

19 I think what you are suggesting is, well, okay,
20 let's accept that point but if the entrant actually is
21 another Royal Mail in its entirety, then we don't need
22 to worry about the damage created in the USO services
23 because the entrant will take over them all.

24 I think my comment on that is we're now very far
25 away from the real world situation faced, which is

1 nobody I think has ever suggested that an entrant into
2 bulk mail was likely to be able to take over the
3 entirety of universal services and the network.

4 Q. I was careful not to turn it into a universal service
5 question, Mr Matthew. You were very keen for it to move
6 to being a universal service question.

7 Isn't the proposition that if an entrant is less
8 efficient in relation to the services in question it may
9 not be able to displace Royal Mail in the long run and
10 you will end up with consumers overall paying more for
11 two sets of network costs?

12 A. Well, if it's less efficient or more efficient in the
13 activity we're concerned with, here bulk mail, then you
14 can have that effect. My point is that that doesn't
15 tell you about the ability of that entrant to replace
16 the entire network.

17 Q. But what you do accept is that you generate, create
18 a situation where you do have two sets of network costs
19 which do potentially inure to consumers' detriment;
20 that's correct, isn't it?

21 A. I think it's unlikely. Sorry, the duplication of costs
22 in bulk mail, so we have a situation where let's imagine
23 Royal Mail is competing in bulk mail, so it cuts its
24 price in bulk mail, for example, but it turns out the
25 entrant can make a profit. So they come in, they have

1 the effect of adding to the competitive constraints
2 faced but they can survive it, and you end up with
3 a situation where you have more competition in bulk mail
4 and you have a situation where the entrant can cover its
5 fixed costs.

6 There is a loss of productive efficiency in the
7 sense that there are now duplication of fixed costs, and
8 Royal Mail certainly loses profits in this process, but
9 that's competition. So within bulk mail there is
10 nothing non-standard here. The only non-standard bit is
11 that we then have this potential for the USO network to
12 start failing to recover its costs, which is the point
13 you made to me. If it's otherwise break-even then by
14 losing one source of profit it may start to go under
15 water for the whole network and Ofcom has its objectives
16 in those areas, but that's not standard, usually you are
17 interested in foreclosure of the market concerned, not
18 possible knock-on effect somewhere else in the economy.

19 Q. Just to be clear, you are recognising that productive
20 inefficiency can be generated and I think you recognise
21 that that can lead to consumer welfare detriments; am
22 I understanding correctly?

23 A. Within the market concerned productive inefficiency of
24 that nature typically shouldn't lead to consumer welfare
25 detriment. It might lead to a reduction in what we call

1 social welfare, which is the aggregation of consumer and
2 producer welfare, but within that market you would not
3 expect a viable rival to have consumer detriments
4 because it will drive down the price not put them up, so
5 consumers are presumptively better off.

6 Q. Even in the case of a multiproduct firm you contend that
7 that is the case?

8 A. The multiproduct firm, the possibility arises that they
9 cannot recover the costs of the whole network in which
10 case there could be an effect elsewhere, and as we
11 discussed that (a) is non-standard, that's taking into
12 an argument that competition in one of the products
13 provided is undesirable, whether it's efficient or
14 inefficient in relation to that particular product and
15 saying, well, I should be blocking competition for this
16 particular activity because I'm worried about the
17 knock-on effects of cost recovery elsewhere, and that's
18 precisely the argument that Royal Mail has made over
19 many years and which Ofcom has spent extensive amounts
20 of time considering.

21 Q. Just in relation to that, are you saying that there
22 would be no possible reaction that could create consumer
23 welfare detriments, for instance in relation to the
24 raising of retail prices?

25 A. I haven't looked in depth at what happens to the USO

1 services. There is a number of constraints on the USO
2 side, and -- which may mean that they can't. I need to
3 go into why they're setting the prices they are there.

4 Q. What about in relation to bulk mail? It's possible that
5 those prices could rise as well, isn't it?

6 A. That's unlikely. You have more competition --

7 Q. But it is possible, isn't it?

8 A. Well, my presumption is you wouldn't expect that, if
9 there is good reason to expect that they would I would
10 want to see that laid out in some depth. But generally
11 you would expect more competition will drive down the
12 prices.

13 Q. I think you accept that you have a presumption, but
14 there is a possibility of the prices rising; that's
15 correct?

16 A. Well, my presumption is that they go down.

17 Q. I understand that. That isn't the point, Mr Matthew.
18 Just let's look at the USO response point that you make.
19 You say: well, Ofcom are keeping under review the
20 position in terms of total cost recovery. But if what
21 you have here is inefficiency in part of the market, due
22 to duplication of costs, do you recognise that other
23 activities of Royal Mail which may be being undertaken
24 very successfully elsewhere would mean that overall it
25 was not necessary to intervene but you would be

1 protecting productive inefficiency in bulk mail in
2 circumstances where you decided not to intervene
3 overall?

4 A. Sorry, I've lost the thread of your question.

5 Q. I'm so sorry, that probably was too long.

6 In circumstances here where you have inefficiency in
7 this part of the market, duplication of costs, but
8 overall Royal Mail by activities elsewhere is generating
9 sufficient returns that, in Ofcom's view, there isn't
10 a need to intervene to protect the USO, you would be
11 maintaining productive inefficiency in this part of the
12 market and you wouldn't be intervening in any way; is
13 that correct?

14 In other words, you look at all these things in the
15 round; you don't look at particular parts of the market
16 when you are doing the overall USO calculation. Is that
17 correct?

18 A. So how precisely does Ofcom go about doing the USO
19 evaluation, is there a threat? Sorry, is that the
20 question?

21 Q. That's part of it. Because Ofcom, I think you
22 recognise, looks at the USO monitoring as a whole.
23 That's correct, isn't it? The total return for
24 Royal Mail.

25 A. Yes, I think so, it uses this EBIT threshold along with

- 1 other factors, as I understand it.
- 2 Q. So if Royal Mail is doing particularly well in other
3 areas of its business, Ofcom won't intervene in relation
4 to the bulk mail market even though there may be strong
5 indications of productive inefficiency; that's correct,
6 isn't it?
- 7 A. So your point is, if I understand it rightly, here we
8 have a loss of profits in bulk mail that arises from
9 competition and therefore duplication of fixed costs,
10 which reduces Royal Mail's profit overall from the
11 network but, because other products are sufficiently
12 high profits, the network costs are covered and there is
13 therefore no reason for Ofcom to be intervening to save
14 the network; then that makes sense to me, yes.
- 15 Q. But you would then just perpetuate productive
16 inefficiency in this part of the market and not
17 intervene; that's correct, isn't it?
- 18 A. Well, I think you continue with your presumption that it
19 was right to say competition in bulk mail should be
20 allowed, and because it will deliver you benefits in
21 bulk mail and won't have the potential negative effect
22 of meaning that Royal Mail can't finance universal
23 service any more.
- 24 Q. If you had a situation where, even looking at it in the
25 round, it's decided that actually the thresholds aren't

1 met, so Ofcom had to intervene, then in those
2 circumstances unless it reverses this particular
3 productive inefficiency, then customers somewhere will
4 suffer, for instance if you have to bring in a levy or
5 allow prices to rise to deal with the problem; do you
6 accept that?

7 A. So if the USO starts to run into trouble and bulk mail
8 is one of the contributory causes, competition in bulk
9 mail, then you need to think about what happens then,
10 and if that was the case then various things might
11 happen, and ... yes, I mean, I think what happens then
12 depends on the circumstances and what Ofcom actually
13 does about it depends -- I'm afraid I don't ... that's
14 beyond where I've got to.

15 I mean, of course Ofcom looked at all that with
16 a view to what was expected to happen and took the view
17 that competition in bulk mail shouldn't be blocked. So
18 obviously if they thought that competition in bulk mail
19 was going to rip holes out of the universal service such
20 that it couldn't be financed, then that would have been
21 a relevant consideration.

22 Q. Just in terms of the practicalities of these issues,
23 Ofcom appears to recognise that Royal Mail has
24 commercial freedom to set prices, but in terms of it
25 considering when and how to intervene in relation to the

1 USO, it's right that Royal Mail has legitimate concerns
2 as to the speed with which and the level of protection
3 that Ofcom will offer Royal Mail in the face of concerns
4 regarding significant or potentially significant
5 financing shortfalls over the long term; is that
6 correct?

7 A. You're asking me for a view on whether Royal Mail should
8 have concerns about the USO? They have advanced lots of
9 concerns, I think, in the past. I'm not that familiar
10 with all of the details.

11 Q. Can I just move on, then, to the question about whether
12 or not an AEC is informative and has been ignored. This
13 involves going back to the decision at paragraph 7.200.

14 A. Yes.

15 Q. So 7.200, you say:

16 "Without prejudice to the reasons outlined above as
17 to why on the facts of this case we do not consider it
18 will necessary or relevant to carry out a price/cost
19 test ... we would make the following brief observations
20 on why the analyses put forward by Royal Mail would not
21 appropriately reflect economic reality given the
22 prevailing features and conditions of ... bulk mail
23 delivery ... at the time [of] the price differential
24 [being] introduced."

25 So it's on the basis of this section, I think, or

1 this paragraph, that you say that no weight at all
2 should be given to the analysis provided by Royal Mail
3 in the course of the investigation which carried out
4 an AEC analysis; is that correct?

5 A. So what this section is saying is that whether it's
6 a price/cost test or the exercise I described earlier,
7 an attempt to use price/cost evidence to evaluate what
8 the incentive effects of the price differential were
9 likely to be, we looked at it, and we thought that the
10 work of Compass Lexecon and Mr Harman told you
11 absolutely nothing about whether the real world entrant
12 would be able to survive and find itself incentivised to
13 continue its entry from that evidence.

14 Q. I see. So, just to be clear, the evidence you would be
15 requiring from Royal Mail in order to meet that would be
16 evidence from Royal Mail that a real world entrant would
17 be able to enter and roll out in the face of the price
18 differential; is that correct?

19 A. In the evidence ... for evaluating the impact on the
20 entrants in the (inaudible - coughing) you need to look
21 at evidence as to what the real world impact would be.
22 Now, as to the nature of that evidence, I think you have
23 various possibilities. One would be to do a sort of an
24 REO version of the -- some of the pricing analysis that
25 was done, so the sensitivity analysis referred to in

1 paragraph (b) was in one way could be viewed as a sort
2 of half step in that direction, but the suggestion is
3 actually that's still not taking it very far. The other
4 is to -- which is what seems more sensible to me -- just
5 to look at what actually happened, what did Royal Mail
6 think the effect of its conduct would be, what did
7 Whistl react with, and what were the steps that resulted
8 from the introduction of the price differential, and
9 that tells you more about what the impact on a real
10 world entrant would be than using the AEC
11 Compass Lexecon Mr Harman analysis.

12 Q. Just to be clear, you are saying that there was no
13 relevance of the AEC test in the preceding paragraphs,
14 and then in 7.200 you are not actually criticising the
15 exercise of the AEC test by Mr Dryden and Mr Harman, you
16 are just saying that that AEC test doesn't reflect the
17 reality of an actual entrant; is that correct?

18 A. Yes, it would not tell you the answer for an REO and it
19 wouldn't tell you the incentive effects. So it simply
20 won't tell you those things, and there was therefore,
21 along with the question of: why do you need to do an AEC
22 at all or a price/cost test at all?, no reason to go in
23 depth into the mechanics of Mr Dryden and Mr Harman's
24 analysis.

25 Q. So just to be clear, when in 7.200(a) you say "The EEO

1 test advanced by Royal Mail is based on Royal Mail's
2 costs, which its own advisers appear to acknowledge are
3 not likely to be similar to those of an entrant", you
4 are not there criticising the exercise of the EEO test
5 using those costs, are you?

6 A. So, no, not in itself. This decision does not present
7 an evaluation of the EEO analysis they did as an EEO
8 test, so it hasn't gone through -- if one had done it,
9 there would have been a lot of questions about all the
10 usual things that come up in such price/cost tests, cost
11 standards, the increments, all those things, what the
12 roll-out pattern should be assumed to have been and
13 Ofcom didn't do that analysis and therefore doesn't know
14 the answer to what such a process might have been.

15 Q. Understood. So your criticism in 7.200(a) is a generic
16 criticism of all AEC tests used in any circumstance; is
17 that correct?

18 A. So it's a criticism of the tests in this case to the
19 extent it tells you useful things about the conduct in
20 this case.

21 Q. No.

22 A. Isn't it? I mean, I don't see there is a general
23 criticism of the EEO tests --

24 Q. I just -- that's not the question I'm asking you,
25 Mr Matthew.

1 This criticism in 7.200(a) can be levelled at any
2 AEC test that's used in relation to any pricing conduct,
3 whether it's low pricing conduct or not low pricing
4 conduct; is that correct?

5 A. So your question, can I just clarify, to me is: is the
6 criticism here something that one could level at other
7 EEO tests?

8 Q. Well, an EEO test used in low pricing practice cases or
9 non-low pricing practice cases.

10 A. So it would be an example of a ... so obviously that
11 isn't the context we were using it, but it would be
12 something -- the observations here might apply if you
13 were in a low pricing practice where there is a debate
14 about whether the EEO or REO standard should be used,
15 and the observation here would be potentially read
16 across, which doesn't mean you should move away from
17 an EEO in whatever these other contexts might be, just
18 to say: well, when you have got a situation where the
19 entrant can't match the position of the incumbents, and
20 you are going to have a debate about whether you should
21 use a REO, these sorts of observations would probably
22 pop up in such a context.

23 Q. Mr Matthew, the question was: this criticism of an EEO
24 test that by using a dominant undertaking's own costs it
25 doesn't reflect the reality of the position of

1 an entrant is equally true in relation to low pricing
2 practice cases, isn't it?

3 A. Well, you say equally true. As a matter of concept, the
4 observation that rivals to the dominant firm may have
5 different costs, I agree that will often be the case,
6 and one of the reasons you use AECs and the EEO test in
7 other contexts is because you want to allow the dominant
8 firm certainty and the ability to compete off the merits
9 of its own cost structure. So I agree with you, if
10 that's your question.

11 As to whether the observations here are equally
12 relevant, I mean, there probably are other cases where
13 there is often there will be no presumption that the
14 dominant firm has a very substantial advantage over its
15 rivals. So we talked about margin squeeze earlier, and
16 I made the point that often in margin squeeze cases
17 where you are considering not the market where the
18 dominant firm has its dominance, but a related market
19 which may well not be subject to the position where the
20 dominant firm has any particular competitive advantage
21 at all, these sorts of issues wouldn't arise equally.

22 Q. But in conditional pricing practice cases they would,
23 wouldn't they?

24 A. In conditional pricing practice cases, in some cases
25 these sorts of things will arise; in other cases, less

1 so. You have to go into the detail. I appreciate the
2 point you are making, because you are talking about
3 competition to the core monopoly. Often it will be the
4 case that the rival has -- faces competitive
5 disadvantages, not always, and the degree to which
6 that's true then goes into what is the increment and all
7 the rest of it.

8 Q. Let's just look at (b) for a moment, sensitivity
9 analysis:

10 "The sensitivity analysis conducted by Royal Mail's
11 advisers assumes a roll-out profile based on
12 Royal Mail's estimates of the likely operating costs of
13 a new entrant and assumes an initial conversion rate of
14 60%."

15 So what has happened here is that there has been
16 a flexing of the terms of the EEO to have this
17 sensitivity analysis, trying to put in some other
18 parameters that might reflect more closely the position
19 of a new entrant; that's correct, isn't it?

20 A. There is two things going on here, and perhaps I can
21 draw a distinction. So we have (ii) which is talking
22 about conversion rates where I agree that is essentially
23 a form of volume adjustment that recognises that the
24 entrant will have lower volumes than the incumbent, at
25 least I think that's my understanding of it.

1 Point (i) I think is less clear. So we're talking
2 here about: how do we decide what roll-out profile
3 should be used in the test, and the argument that's been
4 made is that, for the EEO test, you should use
5 a roll-out profile that reflects the dominant firm's own
6 market position.

7 I'm not sure that's the natural thing to do when you
8 are -- even in a world where you are using an EEO test.
9 In a conditional pricing case, my understanding of the
10 somewhat less usual or less standard EEO test that is
11 deployed there is you basically say: I have an entrant
12 that is competing in some segment of the market,
13 recognising that's not the whole market because it can't
14 cover the whole market, and I'm testing whether the
15 entrant can find it's profitable if it faces the
16 dominant firm's own costs to compete in that segment
17 whilst compensating for whatever the conditional pricing
18 arrangement they have to compensate for is; and,
19 you know, it's a recognised issue in those cases: have
20 you decided what that increment should be, how big is
21 it, over what timeframe and so on? Those tests can be
22 tricky to implement in practice.

23 I think the kick-off point is you do look at where
24 the entrant is actually entering, the segment that
25 they're entering and targeting is the one that you are

1 trying to evaluate the price/cost test for.

2 I simply observe that if you are trying to set
3 an EEO test at where the entrant is trying to enter,
4 that's where it should be directed, and it's not clear
5 to me why it's part of the EEO paradigm that you would
6 essentially adopt a roll-out profile that is based on
7 where the incumbent itself would prefer to enter if it
8 was the entrant, if you like.

9 So on (i) I'm not sure that that is a sensitivity,
10 a step towards REO, I think there is at least
11 an argument that that would be part and parcel of an EEO
12 version of the test.

13 Q. But what you are trying to do is, here, in relation to
14 the roll-out profile, use an approach based on
15 Royal Mail's own costs but flexed for the purposes of
16 the sensitivity analysis; that's correct, isn't it?

17 A. Well, the roll-out -- as I understand it, and I may not
18 have the full details on how Compass Lexecon and FTI
19 actually implemented it, but my understanding is that
20 they ordered a roll-out profile that was based on
21 Royal Mail's own costs and they didn't choose the one
22 that Whistl intended, and that this sensitivity is
23 trying to say: well, now I'm going to relax that and I'm
24 going to use Royal Mail's understanding of what it
25 thought Whistl would want to do, and I have reapplied

- 1 the test, and it gives you a different answer.
- 2 Q. But there are limits to what Royal Mail can know, aren't
3 there, and any dominant company can know? It can only
4 know about its own costs, can't it?
- 5 A. Well, we are repeating a question in the hot tub. In
6 this case, Royal Mail actually did have a go at trying
7 to work out what it thought Whistl would do, and correct
8 me if I'm wrong but I thought the sensitivity here was
9 using the Royal Mail's modelling that it had at the
10 time.
- 11 Q. No. I think that --
- 12 A. So it did have some --
- 13 Q. -- your criticism, if you go on through the paragraph:
14 "Royal Mail doesn't seek to model the actual cost of
15 a new entrant to assess the impact of the price
16 differential on a competitor in that position ..."
- 17 Then you say:
18 "... despite the fact that Royal Mail had developed
19 a 'DDO cost model' as 'a proxy [for] the likely
20 costs'~..."
- 21 So Royal Mail wasn't using that model but you are
22 criticising it for not having fed in its speculations
23 about an entrant into the sensitivity analysis, aren't
24 you?
- 25 A. I'm just observing that if you are going to do an EEO

1 test of the type considered here, you have to take
2 a view about where, which parts of the geographical
3 areas you are going to apply it to. And it seems to me
4 that the first starting point would be apply it to where
5 you -- where the competition is coming, and if
6 Royal Mail doesn't know that, it should probably have
7 a go at trying to work it out. All I was observing is
8 that I thought that this modelling gave it some basis
9 for having a shot at that. As I said in the hot tub, if
10 they weren't sure, imagine they had some idea from
11 general expectations of observing what Whistl was doing,
12 which I think they looked at quite closely, but I can't
13 remember what the facts were about what precisely they
14 knew at the time about where Whistl was expected to
15 target, if you don't know, do an analysis that looks at
16 perhaps the more obvious, more likely or at least check
17 that you are not going to get a very different answer in
18 some of the others.

19 All I'm saying is as a matter of principle, trying
20 to assess the EEO, if you are going to do an EEO test
21 based on where you think the entrant should be aiming is
22 the starting point and then you have an evidential
23 question about how well you are able to do it.

24 Q. So just to be clear on that, what you are saying is that
25 if Royal Mail had done the sensitivity analysis using

1 this direct delivery operating cost model, you consider
2 that that information would have been relevant; is that
3 correct?

4 A. I think I'm suggesting, and that's what it is, I'm
5 suggesting that if you're going to do an EEO test of
6 this type, the part of the sensitivity analysis
7 described at (i) looks to me like something that would
8 be part of your EEO test itself and not necessarily
9 a step to a REO. At least it's not clear to me why it
10 would not be, and I can understand that it may create
11 some evidential questions for Royal Mail in terms of
12 implementation, but those arise with these kind of tests
13 anyway, because whenever you are doing an incremental
14 price cost test at this time, which is not the same as
15 a typical predation or margin squeeze price cost test,
16 you have to look at how big do you think the entry, the
17 contestable part of the market is, and you have to think
18 about where that's targeted. So these issues of
19 uncertainty arise with these tests anyway --

20 Q. Can I just go back to the question? Because I'm
21 conscious of the time. The reasoning you give here in
22 this decision is that the sensitivity analysis is flawed
23 because it still is based on Royal Mail's downstream
24 costs using an adjusted version of Royal Mail's LRIC, so
25 your criticism of the sensitivity analysis is that, and

1 you then say it doesn't seek to model the actual costs
2 of a new entrant.

3 I am saying if Royal Mail had sought to model the
4 actual costs of a new entrant, as you suggest here, are
5 you saying that that analysis would have been relevant?

6 A. So if Royal Mail does a REO test would that analysis
7 have been relevant? Again, my view is you didn't need
8 to do any price/cost test in this case because we have
9 a full picture of foreclosure without it. If you were
10 going to do an REO test then clearly you would need to
11 take steps and you would need to go significantly beyond
12 what is included in the sensitivity analysis.

13 Q. So a modified REO analysis you say would have provided
14 you with relevant information for the purposes of this
15 assessment?

16 A. I don't think I did say that.

17 Q. I'm asking whether or not that's the proposition --
18 I thought I was summarising what you just said. Is that
19 correct?

20 A. I said if you are going to do a price/cost test, and you
21 have agreed it should be an REO test, then you would
22 need to go beyond what's in 7.200(b), that's what
23 7.200(b) is suggesting, along with the more general
24 observation that in this case there is no need for
25 a price/cost test and to examine the incremental effect

1 of the price differential you need to look at the real
2 world evidence, not this form of analysis. It's not
3 your first port of call.

4 MR BEARD: Is now a good moment?

5 THE CHAIRMAN: Always dangerous to summarise what an expert
6 witness says.

7 We will resume at 2 o'clock. Mr Matthew, you know
8 the rules.

9 THE WITNESS: Yes.

10 (1.05 pm)

11 (The short adjournment)

12 (2.00 pm)

13 THE CHAIRMAN: Mr Beard, what is your plan of action?

14 I know it's entirely up to you how you conduct your
15 cross-examination, but can you just give us an update?

16 MR BEARD: Yes, I'm hoping to be done today, so that was the
17 plan.

18 THE CHAIRMAN: Right. We were thinking over lunch you have
19 been covering some ground that was covered in the hot
20 tub.

21 MR BEARD: Undoubtedly. I recognise that.

22 THE CHAIRMAN: It may be taking up time that could be more
23 profitably spent on other issues.

24 MR BEARD: Yes. I'm going to pick up some of those other
25 issues. I'm going to finish off with one or two

1 passages in the decision and then move on.

2 THE CHAIRMAN: Right. But there will be re-examination,
3 presumably?

4 MR HOLMES: I have a small number of questions, four or five
5 at present.

6 MR TURNER: I have two questions.

7 THE CHAIRMAN: Yes. I think I had rather assumed Mr Matthew
8 would be back tomorrow, but I don't want to put him to
9 any unnecessary trouble.

10 MR BEARD: No. I think I am hoping to get done so that
11 those re-examining and cross-examining can finish off
12 this afternoon.

13 THE CHAIRMAN: Let's crack on, that's fine.

14 MR BEARD: Mr Matthew, could we just go back to the decision
15 7.200, I'll move through these bits relatively quickly,
16 if I may.

17 We had looked at 7.200(a) and (b), I just want
18 briefly to look at (c).

19 The contention here is that a potential entrant
20 would take into account risk as well as expected
21 profitability; that's (c)(i), and:

22 "The price differential reduced the upside potential
23 for higher profits from entering into bulk mail delivery
24 and increased downside in the event that entry proved
25 unsuccessful."

1 I will come back to some of those profitability
2 issues in a moment. You here are saying that the
3 measures used by Royal Mail in putting forward its
4 evidence don't include the potential entrant's account
5 of risk, but I think you agree that the LRIC costs
6 measures used by relationship does, so far as Royal Mail
7 is concerned, take into account a cost of capital
8 measure that reflects risk; is that correct?

9 A. It would reflect Royal Mail's risk.

10 Q. Yes. Then if we move on to (ii), here we're talking
11 about what you say are a number of Royal Mail advantages
12 that were touched on in the hot tub and I'm not going to
13 ask about, but there is no consideration of
14 disadvantages here that Royal Mail might have had;
15 that's fair, isn't it?

16 A. Here there isn't, it's an issue that's been canvassed
17 elsewhere.

18 Q. Just if we look at -- just going back a step, I just
19 want to be clear: is it your position that even if
20 a pass of an AECT is not determinative, it's not in any
21 way informative either here; is that correct?

22 A. So, yes, in this context I think it's not informative.

23 Q. So any indication of headroom for less-efficient
24 entrants you say is irrelevant?

25 A. Yes.

1 Q. Yes. Just going to 7.201 in the decision, here it's
2 talking about contemporaneous documents don't indicate
3 that Royal Mail undertook an EEO test. I think I am
4 imagining that from an economic point of view you don't
5 place weight on the fact or otherwise as to whether
6 an analysis has been carried out in advance, do you?

7 A. Placed weight on it for what purpose?

8 Q. For the consideration from an economic point of view
9 whether or not it is appropriate to take into account
10 an EEO test.

11 A. So as to whether such a test was required, I agree;
12 whether or not it's done before or after is not
13 something that's, I think, critical for me.

14 Q. If we go on to 7.202, there is a reference to
15 Royal Mail's contemporaneous internal analysis, it's
16 said to be consistent, and it's said:

17 "Based on our assessment of all the circumstances,
18 the price differential was reasonably likely to give
19 rise to a competitive disadvantage ..."

20 So here you are saying:

21 "... the price differential was reasonably likely to
22 give rise to a competitive disadvantage, as explained in
23 the first part of this subsection E above."

24 So what you are doing here is referring back to
25 factual information concerning the profitability aspect;

1 is that correct?

2 A. It probably is. Sorry, I would need to check back to
3 what the first part actually says, but if you mean
4 that's referring to the materiality assessment?

5 Q. Yes.

6 A. Yes, I would take your word for it.

7 Q. Then 202(b):

8 "As to the consequences of the introduction of the
9 price differential on Whistl and LDC", you were saying
10 you take those matters into account, and I'm going to
11 come back to that, the subsequent events issue in
12 a moment.

13 So if we could just move on, then, to issues
14 concerning the materiality analysis, the first point
15 I want to pick up is just in your joint statement with
16 Mr Harman and Mr Parker, point one. So I believe it's
17 in the concurrent evidence bundle at tab 2.

18 A. Yes, I have it.

19 Q. Yes.

20 A. Yes.

21 Q. Right. The first point that's highlighted is:

22 "Should the materiality analysis assess the impact
23 of the price differential as if it had been introduced?"

24 You say "Yes, from an economic perspective", and you
25 say that you're only addressing the economic issues and

1 don't comment on legal issues.

2 When you say economic issues, I think one might read
3 that to understand the economic effects or likely
4 effects of actual conduct, but you don't mean that; what
5 you mean is the likely effects of the pricing conduct if
6 it had been implemented. That's correct?

7 A. So the materiality analysis that we're talking about
8 here is the evaluation of what the impact would have
9 been if the price differential was introduced, and
10 that's Ofcom's assessment, and that's what it's
11 referring to. There is then a second stream which goes
12 to trying to evaluate the impact of the introduction of
13 the CCNs but their subsequent suspension, and obviously
14 that's a theme that Mr Harman discusses at some length,
15 and so the observation here is essentially that latter
16 theme is separate from the materiality analysis that
17 Ofcom actually did.

18 Q. Well, I don't want to conflate unduly but what we're
19 dealing with here is a form of hypothetical analysis,
20 isn't it, what would have happened if the prices were
21 charged; correct?

22 A. Yes, so Ofcom's materiality analysis looks at what
23 happens if the prices are charged.

24 Q. And you are saying that from an economic perspective,
25 because you would expect that a dominant undertaking

1 doing X -- sorry, let me put that again.

2 Are you saying that, from an economic perspective,
3 you would expect that a dominant undertaking doing X at
4 some course of conduct has exactly the same effect on
5 the market as an entity saying it will do X at some
6 future date?

7 A. I'm not saying those two things are the same. So
8 I think there is two steps to the assessment. Firstly,
9 you look at if they did X, if the price differential and
10 the CCNs are fully introduced, what's the impact of
11 that? That's what the materiality analysis is getting
12 at in terms of the Ofcom metrics, et cetera. So that
13 effectively evaluates, if the CCNs are there in the
14 market, what's the effect of them on the new entrant?

15 There is then a second question of: well, was the
16 introduction and then subsequent suspension, what was
17 the effect of that, recognising that that didn't proceed
18 to the prices actually being paid permanently, and how
19 does that affect matters? And Ofcom's materiality
20 assessment at that stage isn't picking up those points.
21 Those points, you look at other evidence.

22 What Mr Harman has suggested in his fifth report is
23 that you can use elements of his sort of IRR assessments
24 to try and backtrack and evaluate what some of the
25 effects of the sort of the introduction but then

1 suspension might have been. At least I think that's
2 what he is suggesting. But most of the reports and most
3 of the points that I have considered in the materiality
4 assessment are about what happens if they are actually
5 introduced.

6 Q. Let's just leave aside the mechanism by which they're
7 not introduced, because you have emphasised the
8 suspension provision, and I just want to explore how one
9 carries out an analysis where an announcement of intent
10 to act in a particular way is made, and how that links
11 with an assessment of likely effects.

12 I'm going to just use a different example from the
13 pricing one we have here, just for clarity's sake.

14 Since we're in the bulk mail sector, perhaps we can
15 think about a refusal to give access to Royal Mail's
16 delivery network at all. Now, you would accept,
17 I think, that the impact of Royal Mail actually turning
18 away a customer's mail at an inward mail centre today is
19 a very different impact from the impact of Royal Mail
20 telling that customer it's going to stop accepting mail
21 in six months' time; you would agree?

22 A. Well, it depends on what purpose you're doing this
23 evaluation for. I mean, if the customer is putting in
24 place a set of investments that it intends to use beyond
25 its six months, then what it expects to happen in

- 1 six months' time will be relevant to what it does.
- 2 Q. Relevant I will come back to. I'm asking you whether or
3 not it's the same impact actually being turned away at
4 an inward mail centre as compared to being told that you
5 would be turned away in six months' time. Because in
6 the first scenario the customer has to made immediate
7 alternative arrangements, whereas in the second, it
8 doesn't, does it?
- 9 A. So I agree, for six months, if the customer is able to
10 commercially continue to use them, then it can use it
11 for six months in the latter case and not for the
12 former, so that would be a difference.
- 13 Q. In that six months, it could try to persuade Royal Mail
14 to change its mind, couldn't it?
- 15 A. Maybe. We're talking a somewhat hypothetical situation
16 here.
- 17 Q. Or it could go to Ofcom and ask Ofcom to use its powers
18 to intervene?
- 19 A. Well, it might be able to, but I think the -- moving to
20 this case -- point was: well, what actually happened?
21 What were the actual effects? And essentially the
22 situation faced was: well, while you are trying to
23 persuade Ofcom and have that sorted out, you have this
24 Damocles sword hanging over your entry plan.
- 25 Q. There is a different between a sword hanging over you

- 1 and a horse hair being cut, isn't there, Mr Matthew?
- 2 A. Well, if you have a choice as to whether you are going
3 to enter, which you do prior to entry, that sword is
4 a risk to you, and your course of action is -- well, if
5 I know if the sword falls I don't want to be there,
6 I don't want to enter and you probably would want to
7 wait until everything gets sorted out before you are
8 prepared to proceed. So you have an expected short-term
9 impact, and that does derive off the prior, which is if
10 the CCNs are introduced would it have damaged the entry
11 case such that they would not have entered? And that's
12 the evidence in Ofcom's materiality analysis among other
13 things.
- 14 Q. Let's just go back to the six months. You could try and
15 persuade Royal Mail to change its mind, you could ask
16 Ofcom to intervene, you could go and get an injunction
17 from the courts if you thought that there was likely to
18 be a breach of some legal provision, couldn't you?
- 19 A. You might be able to do those things, but since you are
20 thinking: do I press the button on starting my entry,
21 and if I'm the financier, do I sign up to the agreement
22 that hands over the finance for it, you are going to not
23 pursue those things until they get sorted out.
- 24 Q. You are going to delay those things, aren't you? That's
25 what you are talking about?

1 A. That would be at minimum the effect -- well, not at
2 minimum; that would be the effect that appears to have
3 happened here.

4 Q. So it would be a delay but not a lack of investment?

5 A. Well, you get a delay. I suppose we say we agree there
6 is a delay until Ofcom works it out, if things fall in
7 your favour you might then decide to go ahead, in which
8 case there has been a delay. If -- ie the activity is
9 said to be "we're going to block it, it's not going to
10 be permitted", then you would have the ability to
11 rethink, but it would be later on, in this case at least
12 a year later on, and with things being unresolved at
13 that point, as I understand it --

14 Q. But --

15 A. -- you would need to be reappraising in a different
16 market context to the one that you had some time before.

17 Q. Let's just think about that period during the six months
18 of the threat of a refusal to supply. As an operator or
19 indeed an investor, you will have in mind the
20 possibility of changing Royal Mail's mind, succeeding in
21 court or persuading Ofcom to act, won't you?

22 A. You would hope to do that.

23 Q. And so you will take into account in making your
24 business decisions the probability that in fact you will
25 be refused supply in six months' time, won't you?

1 A. Yes, I think that's -- it's true that you would expect
2 someone in that position to have -- to give thought to
3 what are their chances of winning or losing.

4 I do think, however, that there is a methodological
5 issue that does arise. So when Mr Harman has tried to
6 use his assessment to say "Well, I've got my two
7 choices, I enter or I don't enter" and what he has done
8 is, I think, on this particular issue, is said "Well, if
9 I think I have a low probability that the CCNs will be
10 permitted, then that shouldn't affect my entry decision
11 by very much, because I balance off there is a small
12 chance of foreclosure happening but I don't think it
13 will happen and so I trade off those things and I come
14 up with [he says] a positive answer".

15 So given those two choices, what do you do? You may
16 go ahead. But that methodology doesn't allow for
17 a third possibility, which is you simply delay while
18 everything gets resolved, and therefore there can be
19 an effect even if on balance you think the regulator may
20 go your way eventually.

21 Q. So, Mr Matthew, you said you would look at it from
22 a probabilistic basis. Is that from the perspective of
23 a notional rational competitor or investor?

24 A. In terms of the evaluation of what to do faced with the
25 CCNs and perceptions on what might then happen down the

1 line, it would be based on a combination of what
2 Whistl's management thought and what those providing
3 them with the funding thought.

4 Q. So you are saying you have to look at this from the
5 perspective of an actual competitor or actual investor,
6 not some sort of notional rational operator?

7 A. I'm not sure ... yes, you would look at the people
8 involved, not at, for example, an AEC in this situation.
9 I'm not sure about the -- I mean, presumptively most
10 agents in these situations are rational in the sense
11 that they're trying to make decisions that are best for
12 them and their -- in terms of maximising the returns
13 they can make.

14 Q. So what we are talking about here is a probabilistic
15 approach to likely effects because of a range of
16 uncertainties; that's correct, isn't it, Mr Matthew?

17 A. Again, we're focusing exclusively on a situation where
18 there is a -- the CCNs are suspended whilst a regulator
19 review happens.

20 Q. No, I'm not focusing on that suspension. I'm asking
21 you -- I'm going back to the refusal to supply example.
22 That's what I've stuck with. You have a period of
23 six months in relation to which a range of things could
24 happen which mean that the refusal to supply doesn't
25 occur, and I think you have accepted that the way in

1 which one analyses the impact of that is by looking at
2 the probabilistic assessment of the chances of that
3 happening. All I'm saying to you is the reason you are
4 doing that is because there are a range of uncertainties
5 that arise, aren't there?

6 A. Well, I think I accepted that taking judgements about
7 what might happen is part of the assessment.

8 Q. In order to assess the likely impact, in other words
9 whether you go ahead and whether or not you invest, you
10 take a probabilistic approach, don't you?

11 A. Probabilities will feed into it. I made the point that
12 there is an option choice here, which is to delay while
13 you find out what happens, and you may make that choice
14 even if you think the chances of the CCNs being allowed
15 eventually are quite low.

16 Q. Understood. I'm just making a much simpler point here,
17 that you have a range of uncertainties that you are
18 factoring into the likely impact -- the impact of the
19 statement that has been made that refusal to supply will
20 occur in six months' time. That's what you are doing
21 here, isn't it?

22 A. I'm sorry, I'm losing the thread of the analogy.
23 I agree that when there is uncertainty, agents will take
24 a view as to what they think might happen and that view
25 will be probabilistic in nature --

- 1 Q. But when you are --
- 2 A. -- because it is then the analysis of how they act on
3 that that becomes the important point.
- 4 Q. But when you are talking about the likely impact or
5 effect of that statement that refusal to supply was
6 going to occur in six months' time, what you are doing
7 as an competitor or investor is considering the
8 likelihood of that occurring, aren't you?
- 9 A. The likelihood could feature but, as I said, you have
10 an option here which is to delay and find out what
11 happens, and that seems to fit with at least some of the
12 evidence that is in the decision about what actually did
13 happen.
- 14 Q. Just to be clear, the sorts of uncertainties that
15 a competitor or an investor will take into account will
16 be a whole range of potential factors, won't they?
- 17 A. I agree.
- 18 Q. And there are all sorts of actions that, for instance,
19 a dominant undertaking can undertake that could create
20 uncertainty and couldn't be ignored in the market;
21 that's correct as well, isn't it?
- 22 A. Yes, there is uncertainty and part of that uncertainty
23 is, for example, what the dominant firm's reaction might
24 be, for example, to if you enter, how will they react in
25 their prices, et cetera.

1 Q. So that uncertainty will always be there in the market
2 and it may get greater or lesser depending on statements
3 made by the dominant undertaking; correct?

4 A. That's not the totality of the uncertainty --

5 Q. No, no, sorry, I was just picking --

6 A. -- there is -- yes, there will be uncertainty and what
7 dominant firms say they're going to do could form part
8 of the matrix that people take into account.

9 Q. An indication by the dominant undertaking that it
10 considers a particular course of conduct to be lawful,
11 that would be a relevant part of that as well, wouldn't
12 it?

13 A. I think potentially. I mean, thinking about the
14 decision of: do I delay or should I go ahead? Which,
15 you know, there are costs to delaying, in particular you
16 are in a declining market and there are reasons to think
17 that if you keep leaving it your future profitability
18 eventually will diminish. But, yes, I think if you
19 believe that this is going to be a long drawn-out affair
20 and that there will be appeals and the dominant firm is
21 determined of trying to use whatever levers it can to
22 get the best chances it can to get either Ofcom to agree
23 or at least spin it out for as long, then that would be
24 something you would take into account. As I understand
25 it, it's not my evidence, but that's the suggestion of

1 some of the actors involved is that is one of the things
2 they were worried about, that it would take a while --

3 Q. Can I pick up one of the things you just said there. In
4 relation to appeals, I understand your position to be
5 that if the dominant undertaking says "I am intending to
6 do this and will defend it in court proceedings because
7 I consider it to be lawful", you recognise, I think from
8 what you have said, that that can create uncertainty in
9 the market?

10 A. Yes, I think in a situation like this, and we're looking
11 at the factual evidence, as I understand it, about to
12 what extent did the introduction but suspension of the
13 CCNs have a real effect in the market, then I agree that
14 perceptions as to whether the dominant firm is likely to
15 try and pursue those courses and perceptions as to its
16 likely success if it does will feature in the decision
17 of the entrant.

18 Q. But you are not suggesting that a dominant undertaking
19 shouldn't be able to go to court and defend itself
20 vigorously, are you, Mr Matthew?

21 A. No.

22 Q. That could generate significant uncertainty, you
23 recognise?

24 A. Yes, so when you started off a course of conduct, the
25 question is: is that course of conduct itself

1 anticompetitive? Here we're talking about what were the
2 effects of starting that off but suspending whilst
3 things were sorted out, and the question to me is
4 whether or not factually that then still has an effect,
5 recognising that the prices aren't actually being paid
6 in the interim.

7 So I'm not suggesting, or at least I haven't really
8 considered whether the action of defending your legal
9 position spins that out. It would do, but that's not
10 its -- the problem here. The problem here is you have
11 introduced it in the first place and therefore all of
12 those consequences follow.

13 Q. If you believe that what you are doing is lawful and
14 then you seek to defend your position, you will generate
15 uncertainty as the dominant undertaking; you recognise
16 that, Mr Matthew?

17 A. Yes.

18 Q. But you are not remotely suggesting that that could
19 amount to abusive conduct, are you, Mr Matthew?

20 A. Defending a position? No.

21 Q. Now, there are many ways, I think we've agreed, that
22 a dominant undertaking could create uncertainty in the
23 market, but I understand that you are not suggesting
24 that they're all problematic. So, for example, you
25 don't suggest that in 2012, when Royal Mail said that it

1 wanted to introduce a price differential and proposed to
2 do so, that that in and of itself was problematic; do
3 I understand you correctly?

4 A. I haven't even considered that question --

5 Q. I see. What about -- I'm sorry.

6 A. I agree with you in general, there is a point at which
7 something becomes sufficiently concrete that it starts
8 to have real effects and maybe it does, but starts to be
9 something that might be legally questionable but that's
10 really not something that I've looked at.

11 Q. You have not looked at that, but you recognise that
12 a statement of that sort, a clear statement of intent,
13 could have those sorts of uncertainty generating
14 effects, I think?

15 A. Economically, it is true that that -- such things could
16 have an effect. But whether that gives rise to a legal
17 liability really isn't for me.

18 Q. No. So when we talk about the potential impact of the
19 CCNs, what we're really talking about here is the change
20 in the level of uncertainty that those CCNs generate,
21 aren't we?

22 A. Well, my analysis focuses on what happens if the CCNs
23 are introduced. That's what I've focused on.

24 Q. Yes.

25 A. That's where the debate about AEC tests has existed and

1 that's where most of the discussion with Mr Harman,
2 until his fifth report, resided. Those were the
3 questions that we had been considering. Moving back to
4 the question of: was the introduction about the
5 suspension having a significant effect on the
6 marketplace?, to me is a matter of fact. There is then
7 a separate legal debate about whether or not that
8 process amounts to anticompetitive course of conduct in
9 the sense that, well, it would have been if they had
10 done it but actually they didn't go all the way. That's
11 just not my area of evidence.

12 Q. No, but I'm looking at it from an economic point of
13 view. What I'm just exploring with you is whether the
14 CCNs themselves then being issued in January 2014, the
15 impact of those CCNs in circumstances where all market
16 participants knew that following a complaint they would
17 be suspended, the economic impact of those was the
18 change in uncertainty in the market in relation to, in
19 particular, price differential, wasn't it?

20 A. The economic impact is: you will await and see. The
21 economic impact is to create an option value of waiting.

22 Q. No. Just to be clear, that is the consequence of that
23 uncertainty, but the economic impact is the uncertainty
24 being generated itself, isn't it, the likely effect?

25 A. (Pause). The economic impact is: I have an entrant,

1 they face an increased risk -- so this is your point.
2 Is your suggestion that there was no -- there was
3 a large prior risk, so the announcement made no
4 difference to the choice ... essentially because Whistl
5 expected the price differential to be introduced before
6 it actually was, the actual announcement of the
7 introduction of the CCNs made no difference to any of
8 the judgments concerned? I think that's the point you
9 are getting at.

10 On that, you go to the facts. I mean, the facts
11 seem to be it did make a difference, so I'm really not
12 sure where that takes you.

13 Q. Well, let's just try it one more time. I'm testing with
14 you from an economic perspective, if you have contract
15 change notices on pricing being issued where all the
16 market participants knew that such changes might be
17 proposed and knew that if they objected they could be
18 suspended, the economic impact is in fact the increase
19 in the level of uncertainty caused by those CCNs.

20 That's correct, isn't it?

21 A. The increase in the level of uncertainty -- well,
22 I think it's the increase in risk that you are exposed
23 to these terms and conditions, and the impact that has
24 both on your own perceptions, those of other market
25 participants, those of your investors, and that goes to

- 1 the evidence as to what the effect actually was.
- 2 Q. We know that the CCNs themselves weren't the real
3 problem, because we know that Whistl says that matters
4 remained uncertain even after their suspension, don't
5 we?
- 6 A. Whistl says they remained uncertain, yes, and so they
7 were waiting to see, as I understand it, to see -- to
8 have it sorted out.
- 9 Q. That was true even after they were withdrawn, wasn't it,
10 Mr Matthew?
- 11 A. There was still uncertainty about what might happen
12 then. I understand there were perceptions, yes, what
13 would happen at that point. So they were still seen as
14 risks because -- get this right. So Ofcom had released
15 a regulatory decision that would amend the zonal tilt
16 and would preclude the price differential, if
17 I understand it rightly, and was consulting on those
18 proposals. I think in the decision it suggests that
19 LDC, the investor, essentially saw this as a precursor
20 to a further round of regulatory debate, it decided it
21 had lost its patience, but that's not my facts, that's
22 the facts that are not really --
- 23 Q. Okay, you don't -- your --
- 24 A. -- my focus, my focus is much more on the early period
25 where it does appear that --

1 Q. Right. In this early period, the conduct that's
2 creating the market effects here is Royal Mail
3 maintaining a public position that it can do and wants
4 to do something that is, let's say for the sake of
5 argument, later found to be unlawful; that's correct,
6 isn't it?

7 A. I think it is, yes, it is doing something that if they
8 are advised is going to eliminate entry, and leaving
9 them hanging over the market suspended in a fairly -- in
10 an active way seems on the facts to have had an impact
11 on what market participants actually did, which does fit
12 with the economics of, you know, you are faced with this
13 risk, it's better to wait and see.

14 Q. Just to be clear, this Damoclean sword that you referred
15 to, it could have been differently shaped, couldn't it,
16 it could have been a low pricing practice sword? In
17 other words, Royal Mail could have indicated publicly
18 that it wanted to engage in what you refer to as a low
19 pricing practice, whatever that may be, and that could
20 have engendered uncertainty in the market; that's
21 correct, isn't it?

22 A. Well, I think, as we discussed this morning, there are
23 a variety of ways in which entry can be made more
24 difficult, some of them competitive, some of them not.
25 If you're speculating on the possibility that Royal Mail

1 might have done, you know, say for example if the impact
2 thought that the normal pricing reactions of Royal Mail
3 would be very aggressive, in the event it enters, that's
4 something you will find in the textbooks as a reason why
5 people may not enter. It doesn't necessarily even
6 require an announcement, it just requires an evaluation
7 of what you think your incumbent -- how you feel your
8 incumbent is going to react.

9 So, you know, a risk of reaction that makes your
10 entry unprofitable at some future point is something you
11 would take into account.

12 Q. Just to be clear, if the CCNs had been suspended the day
13 after they were introduced, do you think this in any way
14 changes the analysis you have put forward?

15 A. So they're introduced then suspended immediately?

16 Q. The following day.

17 A. For me, it wouldn't materially alter the substantive
18 assessment, because you would be leaving the CCNs
19 hanging over the market while it was sorted out.

20 Q. Could we just go back to your joint report at page 6,
21 bottom of the page. You make a point that I think is
22 referred to as a circularity point, because you say
23 that, as you already stated, that your assessment of
24 materiality is based on your economic assessment if the
25 price differential had been imposed, and you say:

1 "Ofcom's approach makes economic sense. The aim of
2 Ofcom's assessment of the impact of the price
3 differential on Whistl's profits is to understand the
4 likely impact of the price differential on an entrant if
5 it was implemented. Mr Harman says that assessing these
6 matters needs to factor in the entrant's expectations of
7 whether or not the price differential would actually be
8 implemented in practice. Those expectations turn on the
9 same assessment, whether the price differential might be
10 found unlawful or not. This argument seems circular.
11 For example, if there was a 100% probability that the
12 price differential would be found unlawful, the
13 materiality assessment advanced by Mr Harman would find
14 zero impact, hence the price differential would be
15 lawful. From an economics perspective, I therefore do
16 not agree that materiality assessments should factor in
17 the possibility the price differential might be found to
18 be unlawful."

19 Now, just taking it in stages, if a price
20 differential were not -- if you were certain that
21 a price differential were not going to be implemented,
22 leave aside law for the moment, but if you were certain
23 that a proposal or a contract change notice was not
24 going to be implemented, surely from the economic point
25 of view that doesn't have a material impact and it

1 doesn't give rise to a concern as to lawfulness, does
2 it, Mr Matthew?

3 A. So to clarify again, my comment in that passage is about
4 the price differential being implemented. So, sorry,
5 it's evaluating the evidence -- sorry, it's evaluating
6 how should you approach materiality to say: would
7 introducing -- and by here I mean introducing it in the
8 market -- the price differential have a material impact
9 on entry?

10 It's saying, trying to argue about whether it's
11 found unlawful or not for that purpose is, it's just off
12 point.

13 There is then a separate question which I do agree,
14 which we have been talking about which is: to what
15 extent does the introduction about the suspension have
16 an actual effect, recognising that that may not be the
17 same as actually introducing the price differential from
18 day one and leaving it there with -- permanently.

19 My observation on the sort of circularity there
20 doesn't apply to that second set of evidence, that goes
21 to another stream, it seems to me.

22 Q. I just want to make sure I understand your answer there.

23 (Pause) Just to be clear, your circularity here is if
24 you are looking at a hypothetical situation then it's
25 circular to say, well, that hypothetical won't occur

1 because it's in the very nature of a hypothetical that
2 you are not assuming it will occur; am I summarising
3 correctly?

4 A. Effectively that's what he is getting at.

5 Q. Now, I want to move on to a different issue in relation
6 to materiality, which is an issue that you consider in
7 your witness statement, where you say that what you are
8 trying to do in the exercise you refer to as
9 a materiality assessment is to assess whether a non-low
10 pricing practice would reduce likelihood of scale entry.

11 Am I capturing the exercise correctly?

12 A. So this is the materiality assessment as intended, so if
13 we had the CCNs, if they are clearly in place, what's
14 the effect? And yes, that is what it was directed at.

15 Q. So the basic intuition here that you are working on is
16 that the larger the increase in anticipated costs of
17 entry, and the greater reduction of forecast profits of
18 entry, the greater the reduction in the likelihood of
19 entry occurring; is that correct?

20 A. So the larger the price differential, the larger the
21 increase in costs, the lower the profits of the
22 entrants, and therefore the lower the likelihood of it
23 occurring, and those --

24 Q. Yes.

25 A. This is a step in that chain of reasoning.

- 1 Q. Yes, is that correct? Thank you.
- 2 So one of your key metrics is to look at Whistl's
3 forecast EBIT for 2014 to 2018 and compare that with the
4 additional costs that Whistl would incur in paying the
5 differential; that's correct, isn't it?
- 6 A. Yes.
- 7 Q. If it helps, it's in your witness statement at 123, and
8 in particular that metric is referred to at (b).
- 9 A. At (b), yes. Yes.
- 10 Q. Yes?
- 11 A. Yes.
- 12 Q. Thank you. So just to be clear what you are doing here,
13 you are not actually comparing Whistl's forecast EBIT
14 absent a differential with its forecast EBIT if paying
15 the differential, are you?
- 16 A. Let me just get this straight: it is the forecast EBIT
17 without the differential is my understanding is your
18 denominator. And then it says separately calculates the
19 differential over the same period, and observes that
20 that is 55% of the EBIT without the differential.
- 21 Q. What you are actually doing is taking the forecast EBIT
22 for 2014/2018 and then compare it with additional costs
23 of the differential, not different forecasts; that's
24 correct, isn't it?
- 25 A. Yes, so it leaves the forecast unchanged, it was

1 a forecast that was assumed no differential and then it
2 compares that, provides a mirror to that against what
3 the higher costs arising from the differential would
4 have been.

5 Q. So you are not taking into account any ways in which
6 Whistl might have re-engineered its business to
7 accommodate the differential, are you?

8 A. No, it just takes the plan prior to the CCNs and doesn't
9 attempt to amend those.

10 Q. Now, when we're looking at this, you can have
11 a situation where relative changes in forecast
12 profitability really don't tell you much of relevance at
13 all about the likelihood of entry, because you could
14 have a very substantial relative change in profitability
15 but, if an investment remains significantly profitable,
16 the likelihood of entry still remains very high, doesn't
17 it?

18 A. It's a possibility. Obviously the larger that change in
19 relative profitability you referred to, if that's what
20 we have in front of us, the more likely it is that you
21 are going to cross from being profitable to
22 unprofitable.

23 Q. But that's the critical threshold, isn't it, moving from
24 being profitable to unprofitable, isn't it?

25 A. It's a -- it's the threshold Mr Harman discusses at some

1 length, yes.

2 Q. No, it's not just the threshold that Mr Harman
3 discusses. That is true, isn't it, Mr Matthew, from
4 an economic point of view? The critical threshold for
5 an investor or an operator is whether or not the project
6 in question is going to be profitable, isn't it?

7 A. So let's assume it's a purely binary decision, forget --

8 Q. Yes, for these purposes, happy with that.

9 A. But let's just assume. So it's either yes/no,
10 entry/not, then I agree that there are two
11 possibilities, entry is either profitable or it's not.
12 Prior to the CCNs, let's assume for the sake of argument
13 it would have been profitable. Also another possibility
14 is it wouldn't have been and you would never have
15 actually had entry. The price differential is then
16 introduced, and that reduces the profitability of entry,
17 and there are two possibilities, either it means entry
18 profitable and you still go ahead; or it takes you over
19 a threshold and you don't enter. Logically that is one
20 way of setting it up. The hard part of course is to try
21 and evaluate in practice, where is that critical
22 threshold and would you go over it? That's actually
23 a difficult thing to do, and one of the points I've made
24 in any report is Ofcom's assessment didn't attempt to do
25 that, it didn't try and do an evaluation of entry first

1 with the price differential and without it, because it's
2 a very hard exercise, and --

3 Q. Let's just -- sorry.

4 A. Mr Harman has made various submissions or comments in
5 his report on that, but he himself doesn't produce
6 a version of doing that either. So --

7 Q. Well, he looks at the internal rates of return, doesn't
8 he, Mr Matthew?

9 A. Yes, but not in the situation that we're talking about,
10 which is where you have a potential entrant making
11 a rational decision about whether to enter or not. He
12 has not evaluated the rate of return with and without
13 the price differential in that context.

14 Q. He certainly has considered internal rate of return with
15 and without the price differential, Mr Matthew. That is
16 not correct. But can we just go back? I'm going to
17 come on to more points in relation to Mr Harman or your
18 critiques of Mr Harman's analysis in a moment.

19 Let's take a step back and deal with the
20 hypothetical. Potential investment has a forecast EBIT
21 of 50% over four years, and owing to some external
22 factor like change in labour laws or raw materials or
23 some other factor, that EBIT drops by 55%, which
24 mathematically is 22.5% as the EBIT. That's still
25 a hugely profitable return in almost all industries,

- 1 isn't it?
- 2 A. Yes, so I agree, conceptually a possibility is that the
3 price differential, in combination with everything else,
4 leaves entry as profitable, and there are some further
5 wrinkles around that. I mean, there is the higher risk
6 of perhaps an even bigger price differential, but
7 conceptually that's a possibility and it is possible
8 that the exclusionary conduct fails, that doesn't
9 actually block entry.
- 10 Q. It's more than possible, isn't it, it's very likely it
11 doesn't, because a rational operator who would be
12 earning well above their cost of capital in those
13 circumstances, would consider an EBIT return of that
14 level very healthy and worth pursuing?
- 15 A. I don't think it is more than likely. These metrics
16 here are taking a very simple comparison. They don't
17 take into account the other parts of the CCNs. And the
18 facts are that shortly after these being introduced,
19 they stop entering. So entry is suspended, and that's
20 difficult to understand if you thought you had a highly
21 profitable entry opportunity even taking into account
22 the price differential.
- 23 Q. Well, I understand that you say Whistl delayed matters
24 because of its concerns about investment, that we should
25 simply rely on that as the indicator of an exclusionary

1 effect. But what I'm asking you is whether or not there
2 are objective metrics that can usefully inform whether
3 or not there is anticompetitive foreclosure by way of
4 your materiality test in circumstances where an EBIT
5 would mean that both the operator and any putative
6 investor would be profitable; and I think you accept
7 that there are?

8 A. So we're talking about what level of evidence do we
9 require? To my mind the materiality evidence here says
10 there is a sizeable drop in the profitability of entry
11 that in circumstances where entry's expected to be
12 challenging anyway, that is likely to significantly
13 reduce the likelihood of that entry occurring, and
14 that's all the -- as far as Ofcom gets to in the
15 decision. We then look at what actually happened and
16 find they didn't enter, faced with the CCNs.

17 Q. Well --

18 A. So that to me adds up to a fairly clear story that this,
19 along with other factors potentially, had a material
20 impact. I think the argument that says, well, it looks
21 really profitable, doesn't it, because it's only 55% of
22 a high level of EBIT or, going to Mr Harman's
23 assessments, the IRR even after the price differential
24 was still 38%, doesn't take into account the other
25 relevant factors in the market and doesn't fit with the

1 sequence of events which are they stopped entry, and
2 that just simply doesn't fit with this venture being
3 highly profitable faced with the CCNs.

4 Q. But if you have seen a situation where the IRR, taking
5 into account the effects of the differential, is 38%, is
6 that not highly instructive, Mr Matthew, that in fact
7 the conduct in question is not foreclosing and actually
8 there are other factors that may be driving the reasons
9 why delay and eventual non-investment occur?

10 A. I think what it tells me, given we have fairly clear
11 other evidence that they did not have a 38% IRR sitting
12 there at this point in time, that that 38% IRR with the
13 price differential is not reflective of the situation
14 faced by Whistl. So -- and it may be, you know, if that
15 38% IRR is well calculated on the basis of a plan that
16 was, you know, highly profitable, it tells you other
17 factors may have been also significant. Where does it
18 take you to? Well, where it takes you to is maybe there
19 were several factors at play here, other parts of the
20 CCNs, other things going on. The issue I have is,
21 though, the finding that with the price differential you
22 calculate an IRR of 38% is simply not telling you about
23 what the situation faced for that entrant was, and it
24 takes you no further to this critical threshold question
25 of whether the price differential is what tips you over

1 the edge from entry to non-entry.

2 Q. Well, let's just think about that. You have got
3 information that the price differential, when taking
4 account of the price differential, you have an EBIT of
5 38%, but you are saying: well, one can ignore that
6 metric and just look at the fact of what you refer to,
7 I think, as exit and draw on an inference in those
8 circumstances; is that right?

9 A. I think you can ignore the 38% as a useful indicator of
10 whether or not the entry plan was still profitable with
11 and without the price differential, and the reason I say
12 that is because by its construction ... I mean, what
13 Mr Harman has done is explicitly isolate the effects of
14 the price differential, so he has calculated it not
15 taking into account other effects that he says were
16 important. So it doesn't tell you what the position of
17 the entrant was at that time.

18 That combined with the fact you then get suspension,
19 which is what I mean by exit, following the introduction
20 of the CCNs, in circumstances where, if it was highly
21 profitable, you would be expecting them to forge ahead,
22 tells you this entry opportunity has stopped looking
23 profitable with the CCNs there/threatened, hanging over
24 the entry plan.

25 Q. Just to be clear, Mr Matthew, in your materiality

1 assessments, you only focus on the impact of the price
2 differential, don't you?

3 A. That's true, and that makes sense, in -- given the
4 nature of the exercise Ofcom is doing here, because
5 Ofcom isn't trying to -- it's not attempting to evaluate
6 the forward looking profitability of the entrant facing
7 all the risks faced with or without the price
8 differential, it is using an admittedly simpler and more
9 indicative assessment that says, well, this looks like
10 a sizeable impact against a variety of benchmarks, and
11 in that context you don't need to take into account
12 everything else because you are not attempting to
13 determine precisely whether you are going across the
14 critical threshold or not.

15 Mr Harman's assessment, however, because he says the
16 objective approach is to do precisely that, does require
17 you to look at all of the factors, not just the price
18 differential.

19 Q. But you are here saying that these comparisons are
20 indicative, whilst at the same time saying that you
21 don't in any way analyse whether or not the critical
22 threshold is crossed or, indeed, whether or not it's
23 close to the critical threshold. So you have no idea
24 here as to what constitutes a sizeable or not sizeable
25 impact for the purposes of whether or not entry and

1 profitability are maintained, do you?

2 A. I think we do have an idea. We have what are agreed
3 indicative metrics that show you this was likely to be
4 sizeable in context. We have the actual decision to
5 suspend. There is also evidence, not really for me, but
6 around the reasons given for that suspension from the
7 participants. So I think you do have an idea, one being
8 that I am reasonably confident that this evidence shows
9 that there wasn't a highly profitable entry opportunity
10 faced with these CCNs. If there was, we would be
11 expecting a very different pattern of events.

12 MR BEARD: I'm conscious of the time. I'm very much on
13 track to ensure we finish this afternoon. Would now be
14 a useful moment to --

15 THE CHAIRMAN: Well, not if we are going to go on after
16 4.30?

17 MR BEARD: No, we are not. I am going to be finished well
18 within the hour.

19 THE CHAIRMAN: In that case, let us pause now for
20 ten minutes.

21 (2.55 pm)

22 (A short break)

23 (3.05 pm)

24 MR BEARD: Mr Matthew, if we could go back to paragraph 123
25 in your witness statement.

- 1 A. 123?
- 2 Q. Yes, it is on page -- actually I'm not going to even
3 give the page number, we are probably working on
4 different bundles.
- 5 A. Yes, I have it.
- 6 Q. This is the paragraph, I think, where you set out what
7 relevant metrics were that you used; is that correct?
- 8 A. Yes.
- 9 Q. Yes, and so if we just take them in turn, in the light
10 of the exchanges we have had, you say:
11 "Price differential amounted to a significant
12 proportion of Whistl's profits as an access operator."
13 But you remained of the view that Whistl was
14 profitable during those years; that's correct, isn't it?
15 Or would have been?
- 16 A. So the second part of your question was: with the price
17 differential, was Whistl still profitable?
- 18 Q. Did you consider it to be?
- 19 A. The whole business or part of it? I mean, I think the
20 entry business will have been making losses in this
21 period.
- 22 Q. You are judging against Whistl's profits as a whole
23 here, aren't you?
- 24 A. Yes, sorry, your question was: was Whistl profitable?
25 The metric is benchmarking the amount paid under the

1 price differential against what the access operator
2 profits were in that period. I think it goes no further
3 than to observe Whistl's essentially going to have to
4 give up, you know, it's the largest access operator and
5 it would have had to pay an amount through the price
6 differential that roughly compares to the operating
7 profits of its access business. That's all it does.

8 Q. You recognised that Whistl and any putative investor
9 would have thought about these issues over a longer time
10 horizon than merely 2013/14; correct?

11 A. I agree, they would.

12 Q. Then if we move to (b):

13 "The price differential amounted to 55% of Whistl's
14 forecast EBIT from its delivery operations between 2014
15 and 2018."

16 You recognise that Whistl's forecast EBIT was still
17 substantial over the period 2014 to 2018,
18 notwithstanding the reduction, don't you?

19 A. So, yes, the price differential is 55% of forecast EBIT,
20 so it would suggest that 45% of it was left standing
21 with this amendment date.

22 Q. And that was substantial, you accept?

23 A. I don't accept it is substantial within the context that
24 we're using the materiality, because other things are
25 going on that are expected to reduce the profitability.

1 As I said, these metrics don't go beyond that. It's
2 just trying to ...

3 Q. The third comparison is with the level of proposed
4 investment which I think from an economic point of view
5 you would accept is a slightly odd comparison to draw
6 between the additional cost of a differential over four
7 years and the overall profits of Whistl's access
8 operator activities; is that right?

9 A. Sorry, are you talking about the 123(c) or are we
10 talking about --

11 Q. 123(c), I'm sorry, yes.

12 A. So 123(c), again as an indicative benchmark, this one
13 seems to be of interest. The chain of logic, I suppose,
14 was -- that Ofcom were using was the LDC investment was
15 seen as an important element of getting the entry going
16 and I guess to the extent we can make -- draw
17 a comparison, the observation is: well, if the price
18 differential adds costs over a period that's roughly
19 comparable to that, that's an indication that it's
20 a sizeable effect on the price, the costs and profits,
21 that's all.

22 I agree with you, it's not an entry evaluation that
23 one would normally do. It's merely a mirror against
24 which to hold the calculation.

25 Q. And any assessment would be over potentially a longer

- 1 period as well, wouldn't it?
- 2 A. So on (c), if you look beyond 2018 then the price
3 differential would have a continuing impact and would
4 get bigger, as an absolute amount, but I agree with you
5 that it may be if the entry had turned out to go well,
6 they may have made more money at that period.
- 7 Q. But we can't tell from any of these metrics, or indeed
8 anything in your witness statement or the decision, what
9 we should be specifically looking for in terms of
10 materiality threshold, can we?
- 11 A. I think you are looking for something that looks like
12 it's a sizeable chunk of the entry profits, that along
13 with other evidence that entry is difficult suggests
14 that the likelihood of entry is significantly reduced,
15 recognising that doesn't tell you it's necessarily what
16 makes entry non-viable, and that's as far as it goes.
17 Then you compare that also to the other evidence as to
18 what actually happened.
- 19 Q. Just on that sizeable chunk approach that you are
20 suggesting there, in relation to materiality, you don't
21 identify whether or not a whole range of other factors
22 such as the performance of the business, its reputation,
23 changes in labour conditions, and a whole range of other
24 factors, might have impacted on, for example, the
25 decision-making of an investor, do you?

1 A. No. And of course it's possible that they may well have
2 done.

3 Q. Just to be clear, I think you gave the answer earlier,
4 but you haven't looked at or asked for Whistl's or LDC's
5 or PostNL's cost of capital, have you?

6 A. Have I looked at their costs of capital?

7 Q. Well, has Ofcom sought or considered?

8 A. Its costs of capital? I think, you will correct me if
9 I'm wrong, I thought Mr Harman's analysis uses
10 an estimate of Whistl's costs of capital of -- I don't
11 know if it's a confidential figure.

12 Q. Don't say it, that's fine.

13 A. It was -- I think he used ... he did have reference to
14 it because his IRR was comparing, compared to that, but
15 I may be misrecollecting.

16 Q. You didn't look at any of these matters; I think you
17 have been clear?

18 A. No.

19 Q. Can I just go back to paragraph 18 in your witness
20 statement.

21 A. 18?

22 Q. 18. 19, I'm sorry, 19. You say there, and I think you
23 refer to it elsewhere, that there was a one-off threat
24 of entry. Do you mean in terms of a window of time,
25 Mr Matthew?

1 A. So there was one potential entrant, and the question is:
2 was it a one-off chance? Ie if entry was -- is the
3 suggestion that entry, if it's delayed, could have come
4 back again, therefore it's not a one-off in the sense
5 that there was a one-off chance at this particular point
6 of time but delay of 12 to 18 months would have left the
7 threat standing? Sorry, is that the suggestion?

8 Q. I'm asking you. It's in your witness statement,
9 Mr Matthew.

10 A. Okay. So what I meant is one-off in the sense that
11 there is one potential entrant here, which I think seems
12 to be generally agreed, that the timing and the fact
13 that, after this episode happens, we have no further
14 entry or perception of a threat of entry, which is the
15 view that Ofcom actually takes following its
16 December 2014 -- sorry, following the decision by Whistl
17 to end its entry in 2015, getting this right, Ofcom then
18 takes a view -- and this is their view, not mine -- that
19 there is no further prospects or threat, and it amends
20 its thinking about what the right approach to the
21 regulatory regime should be in the light of that. So in
22 that sense, it seems to have been a one-off chance, it
23 was ready to go, things have made it so that it didn't
24 happen, and after that the threat has gone and hasn't
25 reappeared. So I think that's what I meant.

1 MR BEARD: I don't have any further questions for the
2 witness. Mr Matthew, the tribunal may have questions,
3 and I believe Mr Holmes and Mr Turner.

4 THE CHAIRMAN: Yes, we have a few questions. Would it be
5 better if we take them before you ask yours? Yes, okay.

6 Questions from THE TRIBUNAL

7 THE CHAIRMAN: Just on that last point, it's assumed that
8 UK Mail is not a final delivery potential entrant. That
9 is because it has another profitable business and does
10 not need to branch out, is that right, because they are
11 the other obvious possibility?

12 A. Yes. I think the -- I mean, I think it's a factual
13 observation that they weren't seen as an entrant and had
14 said that they didn't intend -- I'm sorry, I can't
15 remember precisely what the decision says about it.

16 THE CHAIRMAN: They haven't applied to intervene.

17 A. There is some statement in the decision, I forget
18 precisely what it says, that says they weren't planning
19 to enter, and that my understanding is that they
20 were ... that unlike Whistl they didn't enter as
21 an access operator with the intention of becoming
22 an entrant, whereas Whistl, I think there is some
23 suggestion that they did have that in mind from the
24 outset.

25 THE CHAIRMAN: Well, it goes to Mr Beard's point about this

1 being a one-off possibility.

2 PROFESSOR ULPH: I wanted to ask you a couple of questions
3 relating to the discussion you had this afternoon about
4 uncertainty. So there were two aspects. They are
5 slightly academic questions, but I guess I can do that.

6 So the first one is this: when you were answering
7 about uncertainty, you were talking about a wait and see
8 approach, so I take it you were thinking about a context
9 in which, as you go through time, some of the
10 uncertainties are getting resolved through learning
11 about the possible outcomes. So in that context, does
12 it make a lot of sense to talk about uncertainty
13 increasing at a particular point of time, because some
14 uncertainties get resolved and some uncertainties might
15 open up at that point in time?

16 So there is no obvious metric in which uncertainty
17 is necessarily increasing or decreasing; it's just some
18 uncertainties get resolved, some new ones might emerge.
19 Is that your understanding?

20 A. That's my understanding, and the point is the simple one
21 that here there is some chance of getting it resolved by
22 reaching a decision by the regulatory authorities and
23 that process reveals information, and that's the wait
24 and see observation I made.

25 PROFESSOR ULPH: Yes. I think there are lots of

1 uncertainties which could get resolved in all kinds of
2 ways by waiting.

3 A. Yes.

4 PROFESSOR ULPH: The second point was: do you also recognise
5 in economics that there is a distinction between
6 strategic uncertainty and other types of external
7 uncertainties or strategic uncertainty I think is
8 arising in what we would think of as game theory. So
9 I play a game of chess against you, I don't know what
10 move you are going to make, you don't know what moves
11 I'm going to make, but the way we think about that is
12 working out what are the rational strategies of the
13 players to play in that game, and that's not well
14 described by thinking about attaching probabilities, we
15 try to work it through and look at the outcomes of
16 various strategies.

17 A. Yes.

18 PROFESSOR ULPH: And that's different from the uncertainty
19 you get as to whether it's going to rain tomorrow, which
20 is not a kind of strategic uncertainty.

21 So would you agree that with strategic uncertainty
22 you don't necessarily describe as well through
23 probabilities?

24 A. I do agree. Probability could feature in your
25 appreciation of the strategic uncertainty you face. So

1 if you are not sure what the other person is playing,
2 whether they're playing chess or bridge, and they're
3 deploying an equilibrium concept, may not lend itself to
4 very clear outcomes then probability will still play
5 a role. But conceptually, yes, I agree.

6 PROFESSOR ULPH: Sorry to interrupt. (inaudible) what you
7 do.

8 A. Yes.

9 PROFESSOR ULPH: Okay, thank you.

10 THE CHAIRMAN: I just have one more question. I think we
11 heard it from you this morning, but in relation to
12 question of the AEC test, the decision is fairly clear
13 that in the particular circumstances of this case the
14 AEC test put forward by Royal Mail was neither
15 informative nor would it be determinative. In fact,
16 I put that the other way round, would not be
17 determinative and would not even be informative, that's
18 the position in the decision.

19 A. Yes.

20 THE CHAIRMAN: Are you softening that position in any way in
21 your evidence or is that your position?

22 A. That's my position, yes, my view.

23 THE CHAIRMAN: Right. Does that extend to any AEC test or
24 just the one that Royal Mail offered?

25 A. In this context, I think it would probably extend to any

1 AEC test, but ... is the informative part of your
2 question? I could imagine other analyses that might be
3 informative to some of the evidential questions here.
4 I don't see it would be determinative in this context,
5 though.

6 THE CHAIRMAN: But in this case, Ofcom took a judgment that
7 it would not conduct its own AEC test?

8 A. Yes.

9 THE CHAIRMAN: Okay. Thank you.

10 Further cross-examination by MR BEARD

11 MR BEARD: Before the further cross-examination, just in
12 relation to that, what other analyses are you referring
13 to, Mr Matthew?

14 A. Sorry, I am thinking about informative in the broad
15 evidence as to what is going on in the evidence in the
16 market in this case. As I said, Mr Dryden presented his
17 AEC analysis as saying "Well, I've got my different
18 price/cost margins I earn for different levels of
19 roll-out, which is the standard AEC test", and then he
20 said "And you can use that to infer from that incentives
21 about which level of roll-out to choose by saying "Well,
22 I have evaluated the price/cost margin for this level of
23 roll-out", in his case the entirety of the UK, "as being
24 higher than one, a partial roll-out".

25 So if you were trying to evaluate the incentives of

1 an entrant to roll out, in principle you could use some
2 of that analysis to try and get at that question. In
3 this case, I can't imagine it would be informative, for
4 the reasons we discussed at length in the hot tub and
5 elsewhere. This analysis just doesn't tell you anything
6 about the new entrants' real world incentives.

7 THE CHAIRMAN: You can blame me, Mr Beard, my question was
8 hopelessly open-ended.

9 MR BEARD: No, no, I was interested in the answer as much as
10 the question, thank you, sir.

11 THE CHAIRMAN: Mr Turner, would you like to ask some
12 questions?

13 Cross-examination by MR TURNER

14 MR TURNER: I would like to pick up from that last decision,
15 paragraph 7.199. I don't know if you can pick that up.
16 It's in bundle C1, tab 1, internal numbering page 239.

17 A. Yes, I have it.

18 Q. There are subparagraphs (a), (b) and (c), and you were
19 asked about (a) and (b), which led to essentially
20 a conclusion in (c) that an EEO AEC test is not relevant
21 in these circumstances. Do you remember that?

22 A. Yes.

23 Q. Now, keeping your eye on (a) and (b), Royal Mail's
24 counsel didn't go to the material which is referred to
25 here by Ofcom in parentheses in either (a) or (b) on the

1 question of the usefulness of an as-efficient competitor
2 test in this case.

3 So if we can start with (a):

4 "Potential entry into the bulk mail delivery market
5 was vulnerable to exclusionary conduct."

6 Can we please go to 7.162 to see what Ofcom had in
7 mind. It's on page 229 of the internal numbering. Tell
8 me when you have got it.

9 A. I have it, yes. Do you want me to read it?

10 Q. Yes, read it to yourself.

11 (Pause)

12 A. Yes.

13 Q. So here we have the factors that Ofcom was referring to,
14 and we see in particular that it's got its own
15 underlining in the fourth line:

16 "Whistl was the first example of competition to
17 Royal Mail's delivery market that could potentially grow
18 to scale."

19 A. Yes.

20 Q. "Any attempt to enter at scale or at all faced high
21 barriers ... that growth would also have to be achieved
22 in the context of a declining market."

23 So the first question is: in your view as
24 an economist, is an AEC test, and specifically
25 Mr Dryden's AEC test, suited to dealing with the points

- 1 raised by Ofcom in this paragraph? If not, why not?
- 2 A. (Pause). So this paragraph is discussing the
3 difficulties of entry, which is 7.199(a), therefore it's
4 vulnerable to exclusionary conduct. That's one factor
5 that goes into the weight one might place on an AEC test
6 that won't capture the position of such an entrant.
- 7 Q. To be more specific, Mr Dryden's test, as I understand
8 it, deals with an as-efficient competitor operating at
9 scale consistently at every level of roll-out that is
10 considered. Here, the emphasis appears to be on
11 an entity that could potentially grow to scale. It's
12 with that in mind that I'm asking whether the point made
13 here bears on the suitability of Mr Dryden's approach to
14 the test to dealing with the concern that Ofcom has
15 raised in this paragraph?
- 16 A. There is the AEC concept, which we have just discussed.
17 As to whether they were talking about "could potentially
18 grow to scale", I imagine Mr Dryden would say that his
19 test is calculated at every scale and therefore he's
20 taken into account different levels of roll-out.
- 21 Q. I think what he says is that it's always operating at
22 scale for each level of roll-out.
- 23 A. (Pause). So his test looks at each level of roll-out.
24 So maybe we need to talk about different scales here.
25 There is the scale of roll-out, and then there is scale

1 within the areas covered, and the volumes you assume
2 that the entrant can actually get in those areas, and
3 his test doesn't capture that because it assumes 100%.

4 In terms of the scale, the roll-out, his test does
5 do a price/cost test for each level of roll-out. In his
6 particular version he says that he can therefore predict
7 which one you would choose, and it's the 100% of the UK,
8 although that's plainly not the expectation in practice.

9 Q. All right. Let's go to the next, 7.199(b), the point
10 made by Ofcom there:

11 "Conduct which hindered the emergence of a less
12 efficient scale entrant into the bulk mail delivery
13 market ... was reasonably likely to limit a potential
14 source of competitive pressure to the detriment of
15 consumers."

16 The factors that Ofcom was referring to are
17 identified, if we go back, in those paragraphs, 7.167 to
18 7.171, if you could turn to those, please, that's
19 internal page 230.

20 To speed it up, I think the meat of the points which
21 I would ask you to look at is 7.168 to 7.170, if you
22 want to quickly read that to yourself, to see the points
23 that Ofcom was referring to.

24 (Pause)

25 A. To 170?

- 1 Q. Yes, it's within the paragraphs referred to later on.
- 2 A. So this is a discussion of the benefits of competition
3 and recognises that limiting nascent competition would
4 harm -- well, would forego those benefits.
- 5 Q. In your view, again, is an AEC test, and specifically
6 that adopted by Mr Dryden, suited to dealing with the
7 points being made by Ofcom in this group of paragraphs?
- 8 A. Well, no, because his test will allow the exclusion of
9 a less-efficient operator, which may be the only source
10 of competition you have, and those benefits are derived
11 from that competition.
- 12 Q. Okay. Second question, if you can now turn back to
13 7.199, 7.200, about which you were questioned, you were
14 asked some questions about the next paragraph, 7.200, on
15 internal page 240.
- 16 If you look particularly at subparagraph (b), the
17 sensitivity analysis, and in (b) if you read from
18 "however ...", four lines down, Ofcom says:
- 19 "However, each of the scenarios examined by
20 Royal Mail's advisers is still based on Royal Mail's
21 downstream costs using an adjusted version of
22 Royal Mail's LRIC model, see paragraph 5.46 of the FTI
23 report."
- 24 Are you familiar with what that is referring to,
25 5.46 of the FTI report?

- 1 A. I imagine it's using Royal Mail's LRIC or LRAIC.
- 2 Q. That is right, and for clarity, the FTI report there,
3 you know what that is?
- 4 A. That's Mr Harman's report, I'm not sure which one it
5 would be.
- 6 Q. Yes, it's his first report.
- 7 So the question is: what costs -- first question --
8 does the adjusted version of Royal Mail's LRIC model
9 used in their sensitivity take into account?
- 10 A. So my understanding is it takes into account the
11 additional costs that you incur with a USO network in
12 place which you then extend to use to supply bulk mail
13 and some other types of commercial mail, and I forget,
14 I am afraid, what those other types are. There were
15 a few, a small number of common costs between bulk mail
16 and some of the others, but I'm afraid I can't remember.
- 17 Q. You don't remember the detail?
- 18 A. No.
- 19 Q. Then let me know if you can't answer --
- 20 A. The essential point as canvassed is you are assuming the
21 USO network is in place and therefore the costs of
22 supplying some additional services using it are going to
23 be quite low.
- 24 Q. Against that context, it was put to you in the first
25 half hour or so of today that Ofcom had failed in

1 various respects to take account of the Commission's
2 guidance on Article 102. Could I ask you to pick that
3 up, please, while keeping this open. That's in two
4 places, the cross-examination bundle for Mr Parker at
5 tab 2, or authorities, I think tab 8.

6 A. Yes, I have it.

7 Q. Because there is one part of that that I'm not sure
8 the tribunal has yet looked at on this issue. If you
9 go, please, to internal page 11, paragraph 26, within
10 the heading "Price-based exclusionary conduct", do you
11 have paragraph 26?

12 A. Yes.

13 Q. You will see the first sentence says:

14 "The cost benchmarks that the Commission is likely
15 to use are average avoidable costs and long run average
16 incremental costs."

17 Then there is a footnote, footnote 2?

18 A. Yes.

19 Q. Would you please cast an eye over that footnote, and in
20 particular I would like you to read the final sentence
21 of that footnote.

22 (Pause)

23 A. Yes.

24 Q. Now, the final sentence says:

25 "In situations where common costs are significant,

1 they may have to be taken into account when assessing
2 the ability to foreclose equally-efficient competitors."

3 I would ask you this: is this point in the
4 Commission's guidance relevant to an assessment of the
5 usefulness of Mr Dryden's AEC test, in your economic
6 view, and if so why?

7 A. So this is a point that did arise in the hot tub. So to
8 reprise, the way I think about this is you are thinking
9 about it as an economist, you start off with the
10 limiting case, which is price, price equal to marginal
11 cost as your relevant benchmark. So that one says if
12 I'm going to set whatever the test is to price equals
13 marginal cost, that is giving primacy to productive
14 efficiency and it is the maximum that you would allow
15 a dominant firm to go before it starts pricing at levels
16 which just plainly don't make any economic sense. And
17 when we're referring to AAC here, that's sort of what we
18 have in mind.

19 Then as you step away from that, as the Commission
20 is doing in the main paragraph here, is they're saying:
21 well, price below average avoidable cost looks
22 particularly concerning, but actually price between
23 average avoidable costs and long run average incremental
24 costs, you are into what in predation terms is thought
25 of as a grey area, so you are looking for other evidence

1 of foreclosure, it's less presumptively clear that you
2 are adopting a profit sacrifice.

3 What Mr Dryden and Mr Harman's analysis does is
4 essentially an LRAIC of bulk mail individually and what
5 this footnote is saying, which is the point I made, is
6 that actually once you are moving away from that short
7 run marginal cost standard, conceptually as an economist
8 there is no particular reason to give primacy to the
9 LRAIC of the products, the individual product where you
10 have a common cost of supplying bulk mail and you spread
11 it across your units, you also say: well, why wouldn't
12 you also pay reference to the economy of scope, which is
13 referred to here and what this footnote is saying is
14 well actually if you have got a multiproduct firm using
15 a common network you may need to do that, and as
16 an economist it makes sense to me that you would have
17 that as something you might go to in the cases where it
18 is warranted.

19 Q. So just to bring that to a conclusion, is that point in
20 the guidance relevant to an assessment of the usefulness
21 of Mr Dryden's test?

22 A. So Mr Dryden's test does not take -- explicitly does not
23 take into account that economy of scope. So to the
24 extent you felt that it was necessary to do that here,
25 and you might well do that if you are in an REO

1 evaluation, then this is something you would need to
2 look at as a further step, and that's what Mr Parker's
3 report does in a fairly indicative way by allocating
4 a modest amount of the common cost, that's one way of
5 getting at it, which I think in those kind of cases may
6 well make sense.

7 Q. One last question based on this afternoon's questioning,
8 related to probabilities and certainties, uncertainties.
9 Mr Beard said:

10 "If you were certain that a proposal or CCN was not
11 going to be implemented, surely from the economic point
12 of view it doesn't have a material impact?"

13 If there was evidence of both rivals and customers
14 responding to the announcement of a price notification,
15 from an economic point of view would you expect that to
16 affect your operational decisions in the market?

17 A. Yes.

18 Q. If so, can you explain how?

19 A. Well, if you believe your customers are going to be
20 scratching their heads about whether you have got a good
21 product, because of the Damocles sword, then that's
22 something that will affect your real economic position,
23 so it would be a factor to take into account.

24 Q. And in relation to rivals?

25 A. So in relation to -- you say specifically, do you mean

1 UK Mail?

2 Q. I have in mind the UK Mail evidence that was talked
3 about in the opening submissions.

4 A. I am afraid I can't remember what the --

5 Q. Contact with customers. Maybe you weren't here for that
6 part of the hearing.

7 A. Okay, so this is somebody contacted Whistl's customers
8 and said "this is coming" and that started to lead them
9 to think about changing their perspective on whether
10 they wanted to go with Whistl, is that the point --
11 sorry, I can't --

12 Q. That's the sort of evidence, yes.

13 A. So that obviously could have a real effect, it's not
14 something I focused on.

15 MR TURNER: No further questions.

16 THE CHAIRMAN: Thank you, Mr Turner. Mr Holmes?

17 MR HOLMES: I have just a few questions, sir.

18 THE CHAIRMAN: No fresh ones since lunchtime?

19 Re-examination by MR HOLMES

20 MR HOLMES: No fresh ones since lunchtime.

21 You stated in your evidence this morning that
22 vigorous price competition is generally beneficial to
23 consumers, and Mr Beard put it to you that the words
24 "vigorous competition" do not appear in the decision.
25 Do you recall that?

1 A. I recall that.

2 MR BEARD: I think I said "vigorous price competition".

3 MR HOLMES: Vigorous price competition.

4 Would you review two paragraphs of the decision,
5 please? The first is 7.192(b) on page 237 of the
6 internal numbering.

7 A. Yes.

8 Q. Would you consider also paragraph 7.197 on page 238.

9 (Pause)

10 A. Yes.

11 Q. Is there anything you would wish to add to your evidence
12 on whether the decision encompassed a consideration of
13 the appropriateness of an AEC test when considering
14 cases of vigorous price competition?

15 A. Yes. As I said, I think -- I believe I said this
16 morning although I -- unless I've missed it, the words
17 "vigorous competition" don't appear in the references
18 you have given me, the reference to low pricing is what
19 I think of something similar, and therefore yes, it is.

20 Q. Thank you.

21 The second question: you were asked whether you
22 considered that a margin squeeze entailing an increase
23 in wholesale prices would amount to vigorous price
24 competition or low pricing. Could you please review
25 a paragraph of your expert evidence in this case, which

1 is on page 37 of the internal numbering, and the
2 paragraph is 100. Could you review that, looking in
3 particular at paragraph 100(a).

4 (Pause)

5 A. Yes.

6 Q. Would you like to comment further on this question,
7 having regard to the material set out there?

8 A. Yes. So, as I said, the issue in margin squeeze cases
9 is around the margin, and the concern you have about it
10 I think is -- had very strong parallels with predation,
11 in the sense that we're trying to draw a line as to how
12 far the dominant firm should be able to squeeze and
13 since an important element of that is cutting the retail
14 price of the retail business, you don't want to dampen
15 that or chill that and the references to wholesale price
16 increases are consistent with that view.

17 Q. Thank you.

18 The third question: you were asked whether the price
19 differential involved a price increase in the
20 circumstances of this case, and you said there is
21 evidence about what's going on that is set out in the
22 decision.

23 A. Yes.

24 Q. Can we now look at some paragraphs of the decision,
25 please. The first is on page 37, internal numbering,

1 (Pause)

2 A. 3.69 and?

3 Q. 3.74.

4 (Pause)

5 A. So 3.69 maintains the price increase. And in 3.74 it
6 says when the CCNs are suspended they don't reverse the
7 price change.

8 Q. Is there anything you would wish to add, then, further
9 on the question of whether you consider that the price
10 differential involved a price increase in the
11 circumstances of this case?

12 A. Well, I suppose if it was a price reduction you would
13 expect it to be reversed when you took away the
14 differential, and that isn't what happened here.

15 Q. Thank you.

16 Then one final question arising out of the question
17 that the Chairman asked you following the conclusion of
18 cross-examination. He asked you about the position in
19 relation to UK Mail, and you mentioned that there was
20 a paragraph in the decision which you had in mind dealt
21 on an empirical level with UK Mail's position.

22 Could you turn, please, to page 172 of the internal
23 numbering -- I'm sorry, that's a wrong reference,
24 forgive me. 173. Thank you, yes, 173,
25 paragraph 6.93(d)(i).

1 Is that the paragraph you had in mind?

2 A. Yes.

3 MR HOLMES: Thank you. I have no further questions, sir.

4 THE CHAIRMAN: I think we have concluded, Mr Matthew, you
5 are discharged, you may step down.

6 THE WITNESS: Thank you.

7 (The witness withdrew)

8 MR BEARD: In the circumstances --

9 THE CHAIRMAN: Well, there is a danger we may not see each
10 other for at least six days.

11 MR BEARD: No, it's a terrible prospect, sir, for all
12 concerned.

13 THE CHAIRMAN: We shall bear it with the usual equanimity.

14 MR BEARD: Very good. We will of course update the tribunal
15 on Thursday or Friday morning as to the position of
16 Mr Harman or as soon as we know.

17 THE CHAIRMAN: Thursday or Friday morning. As I say, we
18 must not put any pressure on Mr Harman so he must have
19 his consultation in the normal course of events, and we
20 take the situation as we find it.

21 MR BEARD: Absolutely, and that has been conveyed to him,
22 along with the good wishes of both the tribunal and
23 counsel. All I'm doing is reverting to the point I made
24 right at the outset that we won't be in contact before
25 then.

1 THE CHAIRMAN: It seems to us that we ought to assume we
2 shall assemble on Monday in any event.

3 MR BEARD: Yes.

4 THE CHAIRMAN: It gives us a fixed point around which to
5 plan.

6 MR BEARD: Yes.

7 THE CHAIRMAN: As regards the future conduct, on the
8 assumption that Mr Harman does give evidence, as we have
9 said, we have already adjusted the timing for the
10 written closings. I think we are really quite strongly
11 of the view that the arrangement we would prefer would
12 be the oral closings to take place in the first
13 three days of the week starting 15 July.

14 MR BEARD: And not on the Friday.

15 THE CHAIRMAN: Not on Friday, and for you collectively to
16 have the, whatever days you have in the previous week to
17 deliver your -- prepare and deliver your written
18 closings and to get them to us as soon as you reasonably
19 can, but at the very least by the end of Friday, earlier
20 if possible.

21 MR BEARD: Understood, and I'm grateful to the tribunal.

22 THE CHAIRMAN: Again as another aid to focus if you could
23 make sure that you do relate them within the generous
24 allocation of pages to the list of issues in dispute.
25 That helps us quite a lot.

1 MR BEARD: Understood. I'm very grateful.

2 THE CHAIRMAN: Is that helpful to you?

3 MR BEARD: It's very helpful. If, during the course of
4 preparation of closing submissions, and it's something
5 that we can revisit next Monday, there is a request that
6 we might sit early or late on some of those three days
7 then --

8 THE CHAIRMAN: Well, I was going to say, we are quite
9 willing to sit both early and late if necessary because
10 I think we have given you three days, I think there is
11 a Tuesday where we may have to finish a little early, in
12 which case we would certainly start early, and we are
13 quite willing to make that up on the other days.

14 MR BEARD: I'm grateful.

15 THE CHAIRMAN: I suppose the other thing is to ask Mr Holmes
16 and Mr Turner, hypothetically, are they assuming
17 two days for cross-examination of Mr Harman or one or
18 one and a half?

19 MR HOLMES: Sir, we have been liaising to try to avoid
20 duplication and we would hope this could be done in less
21 than two full days.

22 THE CHAIRMAN: So we start on Monday, all being well, and we
23 take it as it comes on Tuesday?

24 MR HOLMES: Yes, sir.

25 THE CHAIRMAN: Yes, okay, right, so the more time you gain,

1 the more time you have, more writing, a nice prospect.

2 So we will re-assemble at 10.30 on Monday morning,

3 but we expect to hear from you before then.

4 MR BEARD: Of course.

5 THE CHAIRMAN: Thank you, everybody.

6 (3.55 pm)

7 (The hearing adjourned until 10.30 am

8 on Monday, 8 July 2019)

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