

IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1212/3/3/13

Victoria House,
Bloomsbury Place,
London WC1A 2EB

15th October 2013

Before:
PETER FREEMAN CBE QC (Hon)
(Chairman)
CLARE POTTER
JOANNE STUART

Sitting as a Tribunal in England and Wales

BETWEEN:

COLT TECHNOLOGY SERVICES

Appellant

-supported by-

EE LIMITED
HUTCHISON 3G UK LIMITED
TALKTALK TELECOM GROUP PLC
VERIZON UK LIMITED
VODAFONE LIMITED

Interveners

- and -

OFFICE OF COMMUNICATIONS

Respondent

- supported by-

BRITISH TELECOMMUNICATIONS PLC

Intervener

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HEARING DAY TWO

APPEARANCES

Mr. Kieron Beal QC (instructed by Baker & McKenzie) and Mr. Richard Pike (Solicitor-Advocate of Baker & McKenzie) appeared for Colt Technology Services.

Mr. Josh Holmes and Mr. Ravi Mehta (instructed by the Office of Communications) appeared for the Respondent.

Mr. Daniel Beard QC and Mr. Robert Palmer (instructed by BT Legal) appeared for British Telecommunications PLC.

1 THE CHAIRMAN: Mr. Beard, just before you start, we left a question for Mr. Holmes, and it is
2 really up to him when he answers it; if he answers it in the closings that is fine by us.

3 MR. HOLMES: It is a slightly involved answer. I can deal with it now if the Tribunal think that
4 would be helpful or I can deal with it in closing, I did not want to hold up Mr. Beard's
5 submissions.

6 THE CHAIRMAN: I think we are very happy for you to take it in the closings.

7 MR. HOLMES: Very good.

8 THE CHAIRMAN: Provided you do take it.

9 MR. HOLMES: I do have it well in mind, it is in my back pocket and I will come back to it.

10 Thank you, sir.

11 THE CHAIRMAN: Mr. Beard?

12 MR. BEARD: After some initial remarks on law, I will just work my way through the four
13 grounds. I will go to one or two cases if I may. If we could start at authorities bundle 2 tab
14 21. This is an MCT decision. I am not, you will probably be pleased to know, going to go
15 into any of the details of the case, but if we could turn on to p.75 there is a section entitled
16 "Disposing of section 192 Appeals". Paragraph 198 is a description of s.192 appeals and
17 consideration in a previous case.

18 Then, at 199, it says in considering the two bullets referred to in 198 the Tribunal must
19 decide on the merits and do so by reference to the grounds of appeal set out in the notice of
20 appeal.

21 "We will return to the first of these two requirements in due course. Considering
22 for the present, the second of these two requirements, we agree with what was said
23 at paragraph [76] of the Tribunal's decision in *British telecommunications plc v*
24 *Office of Communications* [2010] CAT 17.

25 'By section 192(6) of the 2003 Act and rule 8(4)(b) of the 2003 Tribunal
26 Rules, the notice of appeal must set out specifically where it is contended
27 OFCOM went wrong, identifying errors of fact, errors of law and/or the
28 wrong exercise of discretion. The evidence adduced will, obviously, go to
29 support these contentions. What is intended is the very reverse of a *de*
30 *novo* hearing. OFCOM's decision is reviewed through the prism of the
31 specific errors that are alleged by the appellant. Where no errors are
32 pleaded, the decision to that extent will not be the subject of specific
33 review. What is intended is an appeal on specific points.'

1 Then there is a further consideration of issues relating to the extent of ‘on the merits’. It is
2 focused on pleading and it is focused on what specifically has gone wrong. It is not a full
3 *de novo* hearing; you might be mistaken for thinking that given the nature of the way in
4 which piles of evidence has been put in by Colt in support of this that was not before Ofcom
5 at all.

6 The next case I want to go is *H3G v Ofcom* which is in authorities bundle 1, tab 12. This is
7 a decision, in fact, of the Competition Commission. The reason it is interesting is that the
8 Competition Commission in this case, H3G is fulfilling the role or the merits of appeal in
9 relation to price control that has gone across to it. We are not blessed with the entirety of
10 the epic Decision but, nonetheless, we have section 1. The bit I wanted to pick up was p.7,
11 which is under the heading “Our role” and then “The standard of review”. There is a
12 discussion of all sorts of submissions that were made about how the standard of review
13 works. There is just one paragraph I wanted to pick up, which is on p.10, para. 1.33.

14 “We have also kept in mind the point made by the interveners that Ofcom is a
15 specialist regulator whose judgment should not be readily dismissed. Where a
16 ground of appeal relates to a claim that Ofcom has made a factual error or an error
17 of calculation, it may be relatively straight forward to determine whether it is well
18 founded. Where, on the other hand, a ground of appeal relates to the broader
19 principles adopted or to an alleged error in the exercise of discretion the matter
20 may not be so clear. In a case where there were a number of alternative solutions
21 to a regulatory problem, with little to choose between them, we do not think it
22 would be right for us to determine that Ofcom erred simply because it took a
23 course other than the one that we would have taken. On the other hand, if, out of
24 the alternative options, some clearly had more merit than others, it may more easily
25 be said that Ofcom erred if it chose an inferior solution. Which category a
26 particular choice falls within can necessarily only be decided on a case-by-case
27 basis.”

28 You probably anticipate the submission that it is going to be BT’s case that here Ofcom did
29 have a margin of judgment, it did consider alternative regulatory solutions. We say, in fact,
30 it was not even close between the different regulatory solutions. It was plainly right to go
31 with active service regulation and not introduce passives regulation. So actually the
32 decision was straightforward, but if this Tribunal were to think that, actually, the matter was
33 closer than Ofcom thought, that is not a matter, even on a merits appeal, that justifies
34 overturning the Decision.

1 That is important because, of course, today BT appears supporting Ofcom in relation to this
2 particular appeal, but that is not to say that BT is by any means content with all parts of the
3 BCMR. Far from it, there are many aspects of the BCMR where BT put in substantial and
4 very detailed submissions, much more so than any material ever submitted by Colt. Ofcom
5 did not accept those submissions. That is an enormous source of frustration to BT. BT
6 knows that even where it thinks that Ofcom may have taken a wrong track in a regulatory
7 decision, it cannot just have a second round of evidence in an appeal. It just cannot start
8 over in the CAT, and yet that is precisely what Colt is seeking to do.

9 Just one other case I will refer you to, if I may. It is at authorities bundle 2, tab 23. It is the
10 *Telefónica* decision in the Court of Appeal. This was a decision that was relied upon by
11 Mr. Beal in opening. He did not refer, however, to para.94. It was in his skeleton, I
12 apologise. It is a decision that is, in fact, on appeal to the Supreme Court, because it is
13 concerned with how dispute resolution is supposed to work in non-SMP cases. BT says that
14 the way in which the Court of Appeal dealt with this is wrong in a non-SMP case. In
15 relation to SMP cases, it is perhaps worth picking up para.94. There is a dichotomy
16 articulated by the Tribunal at para.48 of the judgment about the right approach of a
17 regulator in relation to resolving disputes. The Court of Appeal decries the stark choice
18 being there postulated. It says:

19 “... the function and duty of the regulator [is] to consider all the various factors
20 and to assess the balance of advantages and disadvantages, whether proved,
21 probable, likely or merely possible, to take into account the degrees of
22 probability in each case and the respective seriousness of each, and to come to a
23 balanced assessment overall as to what outcome would most appropriately meet
24 the relevant regulatory objectives.”

25 We say that is what Ofcom rightly should be doing in SMP cases, but it is also why, as
26 highlighted by the Competition Commission in *H3G*, you have a situation where, where
27 there are these broad assessments to be made, a proper margin of appreciation must be
28 afforded to Ofcom.

29 As I say, the piles of new material that have been put in by Colt, including a whole new
30 expert report only in reply, makes it quite transparent that this is effectively at a *de novo*
31 hearing. It is the wrong approach for Colt to adopt.

32 Of course, we do not leave it there, because we say it gets much worse for Colt in any event,
33 because we say that the grounds it advances, each of them has no merit, even where it has
34 included so much new material to support them.

1 Before I deal with those grounds, just two points. Cherry-picking: obviously it is used in
2 one sense in the discussion about arbitrage. Cherry-picking is also a criticism of reading
3 reports. The BCMR is a lengthy document. Inevitably in the course of submissions people
4 are going to pick on particular paragraphs. It is not to be parsed like a statute. It is a matter
5 of reading the report or the relevant sections of the report as a whole in relation to the
6 particular issues with which you are concerned. You do not have authorities in the bundle
7 concerning this. It was a matter that was considered specifically by this Tribunal in the
8 *BAA* case at para.20.8. It is clear that when reading a Competition Commission report or an
9 Ofcom report it must be done as a whole.

10 The second thing I will just pick up is a couple of references to European law. Mr. Beal in
11 opening did refer to various provisions of the Common Regulatory Framework, and in
12 particular the Framework Directive. That is in authorities bundle 2, tab 29. In particular, he
13 directed the Tribunal's attention to Article 8 of the Framework Directive, "Policy objectives
14 and regulatory principles", and then he went to Article 8.5 and he read out just one short
15 clause from that by (d). He said that here the Framework Directive tells us that it is a key
16 goal to promote efficient investment and innovation in new and enhanced infrastructures.
17 Yes, that is true; but no, that does not mean that there is any presumption in any direction
18 towards passive remedies. One has to read this as a whole. I am not going to go through
19 the whole of Article 8, but just Article 8.5:

20 "The national regulatory authorities shall, in pursuant of the policy objectives
21 referred to in paragraphs 2, 3 and 4 ..."

22 So you are supposed to be thinking about 2, 3 and 4, and that includes, of course, in 2,
23 protection of particular groups of consumers, those with particular needs and ensuring price,
24 choice and quality, something that, as I will come on to, particularly in relation to
25 geographic pricing, Colt almost wilfully ignored.

26 "... apply objective, transparent, non-discriminatory and proportionate
27 regulatory principles by, *inter alia*:

28 (a) promoting regulatory predictability by ensuring a consistent regulatory
29 approach over appropriate review periods ..."

30 It will be no surprise that BT says the approach being adopted by Colt here is the absolute
31 antithesis of regulatory predictability -

32 "(b) ensuring that, in similar circumstances, there is no discrimination in the
33 treatment of undertakings providing electronic communications networks and
34 services."

1 We accept that is important, and we will come back to the Equivalence of Inputs obligation
2 that applies to Openreach that was put in place as a result of the functional separation
3 following the TSR - again a matter effectively ignored by Colt.

4 “(c) safeguarding competition to the benefit of consumers and promoting, where
5 appropriate, infrastructure based competition.”

6 “Where appropriate”.

7 (d) promoting efficient investment and innovation in new and enhanced
8 infrastructures ...”

9 Ofcom’s analysis was all about ensuring efficient investment.

10 “... including by ensuring that any access obligation takes appropriate account
11 of the risk incurred by the investing undertakings and by permitting various
12 cooperative arrangements between investors and parties seeking access to
13 diversify the risk of investment, whilst ensuring that competition in the market
14 and the principle of non-discrimination are preserved ...”

15 We will come back to the issue of common costs recovery. Common costs recovery is not
16 some sort of protection for BT. Common costs recovery is ensuring that where BT is
17 spending money in order to put in place infrastructure it is properly incentivised to do so
18 because it had the opportunity to recover those costs through its services. That is a cardinal
19 principle of this regulatory regime and indeed all regulatory regimes. Then:

20 “(e) taking due account of the variety of conditions relating to competition and
21 consumers that exist in the various geographic areas within a Member State.”

22 So look at the reality and look at the geography. Then:

23 “(f) imposing *ex-ante* regulatory obligations only where there is no effective
24 and sustainable competition and relaxing or lifting obligations as soon as that
25 condition is fulfilled.”

26 I will not go on to the Access Directive. One can make the same sorts of points there.
27 Just whilst we are in this bundle, and finally on legal issues, there was some distortion about
28 market 4 and market 6 and the different arrangements that have been put in place in relation
29 to market 4 and market 6. I am just going to make a very, very simple and banal point. If
30 one moves on to tab 33, you have got the Commission Recommendation that sets out the
31 different definitions of those markets. I certainly always forget what they are. We are
32 concerned here, if one turns on to the annex, which is the final page in this document, with
33 market 6, which is wholesale terminating segments of leased lines irrespective of the
34 technology used to provide lease of a dedicated capacity.

1 All sorts of points have been made about the PIA remedy, which is a form of passive access
2 that has been imposed in relation to market 4, but market 4, it is just worth dwelling upon,
3 wholesale physical network infrastructure access, including shared or fully unbundled
4 access at fixed location. It is not all that stunning that in relation to market 4, you might get
5 physical access remedies put in place given that that is the definition of “market” you are
6 talking about. So, to conflate the two, as Mr. Beal has sought to do, it is just plainly wrong.
7 I will stop at the law now, and move on to the grounds. Well, ground 1 I can deal with very
8 briefly indeed. Colt, in its notice of application simply constructed a straw man. No-one
9 has ever said that passive remedies and active remedies are necessarily alternatives, least of
10 all what Ofcom said is — given where we are, what incremental benefits are there from
11 passive remedies given the existence already of passive remedies, and then what are the
12 risks of those passive remedies?

13 THE CHAIRMAN: The existence of active remedies.

14 MR. BEARD: Yes.

15 THE CHAIRMAN: I am sorry.

16 MR. BEARD: (I am sorry, the existence of active remedies). Thank you. And then what are the
17 risks of passive remedies? And Colt says, “Well, as things have shaken out, there is no
18 need to pursue ground 1”. That is a very elegantly and decorously deployed fig leaf by
19 Mr. Beal. It is a wholly misconceived allegation and it has been from the start. It is a big
20 shift in the case that Colt is pursuing because the fundamental basis on which it proceeded
21 in its notice of application was wrong. But of course it is not the only big shift, because if
22 we move on to ground 2, of course what was said in the notice of application was that there
23 was a presumption in favour of passive remedies. And the case for this was pure abstract
24 economic theory. I say “was” because of course yesterday in the course of his submissions,
25 Mr. Beal was rather more circumspect about this. At p.5, line 4, what we say the proper
26 analysis of the framework and structure governing passive remedies in principle gives you
27 is, if not a positive presumption that a passive remedy should be allowed, at the very least
28 not the obverse. The obverse is the line that is adopted, with respect, by BT, which it
29 follows, “Because existing leased line market works you don’t need to introduce a passive
30 remedy”. Well, first of all, that is not what BT says, but more importantly for the purpose
31 of ground 2 that is pretty much the end of ground 2. Colt is accepting there is no
32 presumption in favour of passives. It was always wrong. We put in material from
33 Dr. Maldoom, who pointed out that articulating abstract theory is not simply enough. His

1 criticisms of Ofcom are flawed and particularly, given the development of the regulatory
2 history in this market it was a misplaced criticism. So ground 2 fails.

3 But I will just pick up if I may, one or two comments on the TSR. Mr. Beal has showed
4 you some bits going back to 2005 and said, “Well there were in the TSR concerns being
5 expressed about duct access and bottlenecks and innovation and how something needed to
6 be done. Well of course that is true, but something was done. There was a fundamental
7 change in the market because of the TSR. There was a functional separation made within
8 BT. Openreach was created by a series of undertakings that were given by BT following on
9 from the TSR, and those undertakings and that functional separation is something that
10 effectively is being overlooked by Colt, so that those concerns about duct access and
11 concerns about bottlenecks — they were dealt with but they were dealt with by a different
12 mechanism entirely. At that time Ofcom did not say, “Okay, well we will put in place
13 passive remedies”. What it said was, “We will engender functional separation. We will
14 change the way that this market works”. And you cannot, as Colt sometimes rather casually
15 does from time to time, you cannot say, “Oh, but BT favours its own downstream
16 operations”, that is just a myth. BT take very seriously the structural arrangements that
17 were put in place following the creation of Openreach and those Equivalence of Inputs
18 requirements; and the allegations to the contrary are unfounded. There is no basis for them
19 and there is no basis on which this Tribunal can proceed on some suggestion that the way in
20 which BT operates is in breach of those arrangements.

21 Of course there is much more to the regulatory background than just the consequence of a
22 TSR, in fact there are hundreds of pages more just in relation to the BCMR, which is only
23 part of the regulatory structure with which we are dealing in respect of BT and the
24 telecommunications market. Just to pick up one point from yesterday, the basket price
25 control methodology that is adopted in the BCMR is not under challenge, there is no appeal
26 in relation to it. That was Ofcom’s considered conclusion as to how prices are efficiently
27 set in order to ensure that managed competition works as effectively as possible. There are
28 whole chapters of the BCMR dealing with it. You cannot then bring some sort of collateral
29 challenge saying, “Oh no, that’s not an efficient way of pricing as Colt are doing”. Actually
30 allowing BT that leeway within baskets which actually include all sorts of sub-caps and
31 collars and controls as well. It is not just a matter of there being a basket of services in
32 respect of some general price control. You cannot ignore that. You cannot ignore the
33 arrangements that have been instrumental in the development of a £2 billion business in
34 relation to business connectivity.

1 So when we look at the real world, we see an environment where careful consideration is
2 being given to the ways in which a person who has been found to have SMP. At one point
3 Mr. Beal yesterday was striving to give an economic analysis as to why there might be
4 indications that BT had market power in the particular markets. He really does not need to
5 bother in relation to this situation. There is a finding of SMP. We recognise that, we are
6 dealing with managed competition, but we are dealing with it in a world where we are not
7 starting from a blank piece of paper.

8 Recovering efficiently incurred costs — it is a neglected part of the Colt analysis that the
9 regulatory structure must afford BT that reasonable opportunity to recover its efficiently
10 incurred costs. If you do not do that, not only would the regulatory change be plainly unfair
11 to BT, but it would undermine the development of telecommunications in the UK, because
12 BT will not have incentives to invest.

13 Just in that context, it is worth pausing for a moment. These are issues that are actually
14 under consideration to some extent in another appeal that is being brought against the
15 BCMR, which is a price control appeal that has gone off to the CC. But there is a massive
16 exercise involved in BT producing regulatory financial statements in relation to markets
17 where it has SMP. And those regulatory financial statements are then used for the purposes
18 of a very sophisticated cost allocation exercise that is undertaken between the different
19 services that BT undertakes in order that those price controls can then be properly analysed
20 by Ofcom. So, it is not as if BT is somehow making up where it puts costs and how these
21 price controls work, it is a sophisticated and complex exercise which we are being
22 effectively spared here in this appeal; but it cannot be ignored that it is against the
23 background to that very sophisticated exercise that then the price controls are applied by
24 Ofcom. And there are arguments about them. As I say, BT is not happy about all of these
25 price controls, but that is the nature of the price control exercise. But it is important to
26 recognise that the way that BT prices in order to recover those costs is that people who take
27 more capacity pay more. There is a bandwidth gradient. At the same time it prices across
28 geographical areas on the same basis. But this is not cross-subsidisation; it is pricing to
29 maximise output. It might be referred to as a form of Ramsey pricing; it is a form of pricing
30 that Ofcom accepts is efficient, or the most efficient mechanism it can identify in the course
31 of this review. Colt has not properly dealt with that problem at all. Indeed, Colt says we
32 can put in place passive remedies, and when asked about how you deal with these problems
33 at pricing the answer, or at least the principal answer, seems to be FRAND. FRAND is to
34 Colt many things. It is “short and sweet” at p.7 line 3 of yesterday’s transcript. I think that

1 is a statement said without irony. It has a certain “beauty” (line 13), but most of all,
2 “FRAND is an answer” (p.27 line 31). But that is just wrong.

3 In this context FRAND is not an answer; FRAND is a question. It contains a selection of
4 what philosophers sometimes refer to as essentially contested terms, words the meaning of
5 which we struggle to agree on. What would be a fair, reasonable and non-discriminatory
6 price for passive access to a particular piece of duct, or to a piece of unlit fibre? How do
7 you do that? It is effectively a whole other BCMR exercise that is being suggested here. It
8 is a massive exercise and it could not be done easily.

9 What you would need to be considering is how you protect bandwidth gradient pricing and
10 geographically average pricing, because those are things that are efficient in these
11 circumstances.

12 THE CHAIRMAN: Mr. Beard, what is your answer to the question I put to Mr. Holmes
13 yesterday about why is FRAND elsewhere in the BCMR as a remedy?

14 MR. BEARD: Just picking that up, it is not as a remedy though, because actually when you look
15 at those boxes that you referred to, Mr. Chairman, they refer to remedies in the wholesale TI
16 and other markets. It is part of a package of remedies that are being put in place.

17 Just to take the TI one, which is the first of the boxes which is just the one at para.1.51 in
18 the bundle. I do not know if it helps to turn it up. I am happy to do so if that would be
19 useful. It is in the additional materials bundle tab 5 p.12. It is the first of the boxes I think
20 you identified, Mr. Chairman.

21 It is part of a package of remedies in relation to wholesale TI markets. Just to draw one or
22 two points to your attention, what you are dealing with here is a set of detailed
23 arrangements to deal with pricing and terms in relation to a narrow range of particular
24 products. So in relation to these sorts of discretely defined products, you do not have issues
25 about costs recovery and enabling a bandwidth gradient, or protecting geographical
26 averaging, because those things are not affected by the pricing arrangements of these
27 particular active services. So even if you can say: FRAND applies here, you do not have a
28 problem, actually when you look at it what you have is a detailed set of arrangements of
29 which offering fair and reasonable charges, terms and conditions is only one part. Indeed, if
30 you move down to I think it is the ninth bullet point, what you see there briefly referred to is
31 “charge control”. So actually in relation to TI what you have is a complete charge control,
32 a basket charge control that is dealt with elsewhere in the report and then what is being said
33 in relation to the fair and reasonable charges point is in addition to those very detailed

1 arrangements you must put in place any charges within that basket that you can reflect must
2 be fair and reasonable.

3 So why has Ofcom introduced that, because it was not initially included by Ofcom in the
4 proposed remedies? What happened was that certain of the CPs came back and said even
5 where you have got this detailed charge control in relation to this limited category of
6 products, what we are concerned about is the possibility of margin squeeze. So the fair and
7 reasonable terms that are introduced here are essentially intended to act as a further
8 protection in relation to these detailed matters to protect against potential allegations of
9 margin squeeze. But this just is not anything like the FRAND proposal that we are dealing
10 with here, because here you are looking at FRAND using those nebulous concepts to do all
11 the legwork of all of the terms and conditions that deal with issues relating to a whole new
12 range of undefined services, and asking it to do all the work of a charge control. You are
13 asking FRAND to do all this and deal with these issues of costs recovery and incentivising
14 investment which are critical to the way that pricing should work in circumstances where it
15 is obvious that passive remedies can undermine bandwidth gradient and geographically
16 equal pricing.

17 Then it appears to be the case that the argument is: you can have a discussion about what a
18 FRAND price was for a piece of fibre or a piece of duct, and if you could not resolve it you
19 take it to dispute resolution and then you have four months essentially to carry out what is at
20 least as big as the BCMR price control exercise. Yet you do not really know where the ends
21 of this project lie. You are talking about a new way of dealing with regulation. Colt says
22 initially, at the same time as having active remedies, you have still got these sorts of
23 arrangements in place, but you have got to not only deal with the modalities of how you set
24 pricing for passives, but the interaction of those passive arrangements with the actives, all of
25 which will be relevant to any analysis of what is fair and reasonable. Fair and reasonable is
26 fair and reasonable to BT as well as to CPs in this context.

27 So whereas fair and reasonable here is effectively a protection for CPs. When it comes to
28 considering FRAND as a putative answer for passives you are into a completely different
29 world. So in this context FRAND is a question. It is the start of an enquiry; it is not the end
30 of it and the references here are in an entirely different context. I do not know, Mr.

31 Chairman, if that answers your questions on that.

32 THE CHAIRMAN: OK.

33 MR. BEARD: That takes us to ground 3. We have got various issues on ground 3. As Dr.

34 Maldoom has pointed out, a multiplication of remedies, although I suppose one might think

1 the more remedies you have got the better it is, actually does not work like that; it creates all
2 sorts of conflicts, difficulties and tensions and greater risks and greater uncertainties. We
3 talked about the huge risk if the bandwidth gradient for active services collapses. Mr.
4 Holmes showed you yesterday how that was the positive intention of the CPs who had
5 actually put in any detailed submissions. Colt asserts this is a benefit. It is not.
6 Secondly, prices to customers outside the areas where this passive-based competition will
7 actually arise in practice will end up paying more; there will be geographical de-averaging.
8 Colt has not begun to explain why that is a good thing.
9 Thirdly, Ofcom has made clear that you might actually be increasing the total costs of the
10 provision of telecommunications services as CPs install new electronics and new cables and
11 new pieces of kit to essentially do what BT's kit already did. So you increase costs overall
12 but actually customers are not benefiting. The CPs maybe, their shareholders may be
13 utterly delighted, but in terms of Ofcom's submission, that is not the answer.
14 Fourthly, none of what Colt says explains how you deal with these capacity grabs. In other
15 words, CPs trying to get spare duct space or fibre so that they can effectively charge rivals
16 higher prices, obviously not being subject to SMP obligations and that they will, without
17 plundering the images of Morgan Spurlock's Supersize Me, whatever demands they have
18 for duct space or fibre, and then hold on to it.
19 Fifthly, you will deter investment by an incomer because unless the incumbent knows that
20 where it invests the pricing arrangements will allow it the opportunity to recover its
21 efficiently incurred costs, it is simply not going to do so. Colt may be happy to leave things
22 there, but Ofcom rightly is not.
23 Sixthly, and I do not think this should be forgotten, Colt conjures a world in which actives
24 and passives sit together – quite how they sit together remains a mystery and Ofcom has
25 rightly recognised that that is not going to be a happy couple on a sofa; actually, one is
26 going to get evicted and it will be actives. You will be moving to passive remedies and it
27 will be an irreversible change. In those circumstances, a precautionary principle would be
28 appropriate in considering what regulatory change should be made.
29 Against that range of detriments Colt says “No, no, there is substantial evidence of benefits
30 which can be delivered through passive remedies which are incapable of being achieved
31 through active remedies, and “substantial evidence” and “incapable” are terms that Colt
32 quite properly uses as its relevant test – for your notes, notice of application para. 8.2(b).
33 First, Ofcom, in exercising its judgment, has properly considered these factors,
34 infrastructure based competition, innovation, capacity and coverage, efficient use of

1 network assets. So, to some extent, one does not need to get into this because it has been
2 weighed, it has been assessed, and there is not really a basis at all for suggesting Ofcom has
3 gone wrong, and actually when you drill down into those particular challenges none of them
4 suggest either that there is substantial evidence of passive benefits or that those benefits are
5 incapable of being provided throughout active services in this environment of managed
6 competition.

7 Infrastructure based competition – that was initially all about ring architecture in the notice
8 of application, and then it moved on a bit to point to point services, and now it talks about
9 ring topology taking passive access on a piecemeal basis. I do not think we need to get into
10 details of this, but when you start talking about passive access on a piecemeal basis all you
11 are doing is compounding the difficulties as to how this regulatory regime could ever
12 sensibly work. This is far from substantial evidence of new infrastructure competition.

13 Mr. Reid has set out how the architecture that exists can get you benefits of resilience, and
14 there have been all sorts of evidence put forward that Mr. Beal says it is not really necessary
15 to go into. He says that there are case studies on City 1 and, in reply, a second City,
16 suggesting that if there was passive access Colt could expand further and install ring
17 architecture. Well, this just is not substantial evidence, indeed, it is unfounded. There is a
18 wonderful irony about City 1, there are already 8 CPs operating and offering services there.
19 More than that, the way in which the assessment of investment is dealt with is just not
20 tenable. Mr. Reid has dealt with Mr. Fournier’s evidence in this regard and the remarkable
21 repayment periods as being necessary in order to justify investment. It is dealt with much
22 more fully in our skeleton argument at paras. 36 to 44 – I am not going to stray into those
23 confidential materials, but it is not substantial evidence of some infrastructure competition
24 that provides benefits that cannot be delivered by active services. When we come on to
25 innovation and service differentiation, the initial witness statements came out with all sorts
26 of new suggestions that had never been put to Ofcom at all, and when tested they began to
27 crumble. Again, I would refer you to Mr. Reid’s witness statement – his first witness
28 statement in particular – at paras. 55 to 61, about how BT was a driving force behind having
29 the technology referred to Sync-E recognised as an international standard. There are all
30 sorts of allegations about late introduction of a product called “EAD” that the Colt case
31 entirely fails to recognise that predecessor services provided that functionality. It was not
32 delayed or late as suggested. Then there is a discussion of a technology called “SDN”
33 which can clearly be used with active services, and it is one that BT has been developing.

1 In short, it is supposition by Colt, it is not a set of innovations and benefits that can only be
2 delivered through passive remedies at all, and I refer you to our skeleton argument at paras.
3 56 to 59.

4 The third category was concerned with the delivery of capacity and coverage. We are not
5 even sure whether or not this is being pursued, the arguments seem to be that if there were
6 passive remedies which reduced the bandwidth gradient there would be an increase in the
7 consumption of higher bandwidth services. That does not seem to us to be something that
8 is being pursued. It is certainly not something that cannot be offered through active
9 services. Just to be clear, BT recognises that there is a growing demand for high bandwidth
10 services, but it says that Ofcom recognises that that can be delivered through active
11 services. As to the efficient use of assets, it seems in the main to focus on the idea that the
12 PIA remedy that was put in place in relation to market 4 somehow needs to be extended,
13 and it is imperative that it is extended - it creates difficulties if it is not, and creates
14 enormous economy if it is. We simply do not accept that.

15 Just to pick up a point that Mr. Holmes raised at the back end of yesterday, for all the noise
16 about PIA it has not been taken up, it is VULA, the active service, that has been taken up by
17 CPs, and we have dealt with these matters further in Mr. Lazarus' statement and, in
18 particular, the issues concerned with the Equivalence of Inputs material.

19 Just on this Ground 3 – benefits and detriments analysis – Ofcom did weigh them up. There
20 have been recent references in opening to some notion of welfare calculus that has wrongly
21 been undertaken. This way of putting the case is new, it is not something that is reflected in
22 the pleadings, but all it does is put in new terms an allegation that is wrong. Ofcom did
23 weigh these matters up. If it is going further and saying numbers should be attached then it
24 is unjustified.

25 That then takes us to Ground 4. I will not add to Mr. Holmes' account consultation, it is
26 sufficient to say there was ample opportunity, indeed, one CP whose documents we saw in
27 some detail yesterday clearly took it, Colt did not; it plainly regrets that now, but that is no
28 criticism of Ofcom. What is more, when we see all that we have now put in it really does
29 not amount to any good basis for impugning Ofcom's approach in any event.

30 Finally, just on the evidence of investment material, we saw that, certainly, as a cross-check
31 on the balancing exercise that was being undertaken by Ofcom. You do the balancing
32 exercise and then you see whether you have been told anything that indicates some new
33 grand innovation out there that is being held back by the absence of passive remedies, and
34 the truth was that, even after all that consultation, all that is really being suggested by the

1 CPs is: “Can we arbitrage?” It was not a matter of drawing up business plans, and
2 submitting them. It was asking whether or not in this managed competition environment
3 there was some leap that was being prevented; there was none and there is none. There is
4 no merit to the grounds that are being put forward by Colt.

5 Unless I can assist the Tribunal further, those are the opening submissions of BT.

6 THE CHAIRMAN: Is it correct, Mr. Beard that the way you put it, it is almost as if passive
7 remedies should hardly have been considered at all. Is that your position?

8 MR. BEARD: If Ofcom thinks that it is appropriate to consider passive remedies we quite
9 understand that. Those are matters that it is right for a Regulator to keep under review.
10 What we do say is that there are real difficulties with passive remedies being introduced in
11 circumstances where the regulatory regime has been established as it has done, in
12 circumstances where BT offers a range of services as it does, and that before you make any
13 move in relation to the introduction of passive remedies you do properly have to think about
14 what the incremental benefits are. So if Ofcom has carried out that analysis and concluded
15 there are not incremental benefits but, indeed, there are very real risks and very substantial
16 detriments, that is open to Ofcom and perfectly justifiable. That is not to say that you
17 cannot consider these matters.

18 THE CHAIRMAN: Thank you Mr. Beard.

19 MR. HOLMES: I think it falls to me to call our first witness.

20 THE CHAIRMAN: I think we would like to pause, if we may and I think we might like to
21 resume in camera, because I think your witness’s statement does contain some confidential
22 information and it would be appropriate. That will be our comfort break; we will then go
23 through until lunch.

24 (Short break)

25 (For hearing *in camera* see separate transcript)

26
27 DR. ANDREW LILICO, Affirmed

28 Examined by Mr. BEAL

29 Q Dr. Lilico, please could you give your business address for the benefit of the Tribunal?

30 A Europe Economics, Chancery House, 53-64 Chancery Lane, London.

31 Q Do you have before you the core bundle volume 1?

32 A Core bundle Confidential HB1, probably. Yes.

33 Q Turn to tab 8.

1 THE CHAIRMAN: Sorry to interrupt. Just before we get into this, we were not entirely joking
2 before. I think, Mr. Holmes, Mr. Culham's second witness statement which the witness
3 may wish to refer to probably needs to be formally accepted by us so that it is in play.
4 MR. HOLMES: Yes, sir, it was my intention to apply to you.
5 THE CHAIRMAN: Do you want to apply now?
6 MR. HOLMES: I am very happy to do so.
7 THE CHAIRMAN: Then we will agree. Then this expert evidence is all in play.
8 MR. HOLMES: I am grateful, sir. I would, please if I may, apply to the Tribunal to adduce the
9 second statement of Mr. Culham.
10 MR. BEAL: There is no objection. The only reason I raised the issue of BT was that Ofcom,
11 unlike BT, had actually formally applied in their covering letter to the Tribunal for
12 permission to adduce it and we have not raised an objection. So that was the reason.
13 THE CHAIRMAN: That is fine. I think Ofcom formally applied. Anyway, I think it is all fine.
14 MR. BEAL: I am grateful, sir. So may I take it that it is admitted?
15 THE CHAIRMAN: You may.
16 MR. BEAL: Thank you.
17 THE CHAIRMAN: Please proceed.
18 MR. BEAL: Thank you very much. Tab 8, please Dr. Lilico. Is that an expert report that you
19 have prepared?
20 A I have the sign page but this one doesn't have a signature. This one doesn't have a
21 signature on it. It looks like my report.
22 Q I am told apparently the wrong one has been swapped in, and it may have gone behind the
23 next tab, so you may need to do some reconfiguration.
24 A Hah, tab.10. The one there says it's signed by me, 27th May 2013.
25 Q Are the contents of that report true to the best of your knowledge and belief?
26 A They are.
27 Q And behind the next tab, tab.9.
28 A That is tab.9, the one that I just spoke to.
29 Q Would you mind taking out the first report from tab.9 and putting it behind tab.8?
30 A Okay. Yes.
31 Q Thank you very much.
32 A Shall I take out the tab.8 one, or —
33 Q The existing one that is unsigned, if you would be so kind as to take that out, and it will
34 save my learned friends giving me the wrong references.

1 A Okay. Put that over there (just in case).

2 Q Thank you very much indeed.

3 A So, what should be in tab.9?

4 Q Tab.9 should be your second report.

5 A That is the one that you've just given me here.

6 Q Is that signed at the back?

7 THE CHAIRMAN: This is all designed to put you at your ease, Dr. Lilico. (Laughter)

8 A It is! It is!

9 MR. BEAL: A few gentle looseners.

10 A It is signed 14th September 2013.

11 MISS POTTER: Mr. Beal, our hearing bundles do not seem to have an attestation page, actually.

12 They just end at 38. (Brief discussion on bundles and pagination)

13 MR. BEAL: So within tab.9 please can you confirm at p.21 that is your signature?

14 A It is. That's my signature.

15 Q The contents of that report, are they true to the best of your knowledge and belief?

16 A They are.

17 Q And you have indicated in each report that you have read and understood the duties to the

18 Tribunal as an expert witness. Is that correct?

19 A Correct.

20 Q Thank you.

21 (Cross-examined by Mr. HOLMES)

22 Q Dr. Lilico, thank you for joining us this afternoon. I have a few preliminary questions, just

23 about your instructions, if I may.

24 A Okay.

25 Q May I first ask you a little bit about what you have read in preparing the expert evidence.

26 You read section 8 of the statement, of course.

27 A Correct.

28 Q Did you read section 8 of the consultation document which dealt with passive remedies?

29 A I didn't read that in nearly so much detail as section 8 of the document, which was the

30 actual statement. I glanced at that.

31 Q Yes. And did you read any of the consultation responses that were submitted to Ofcom?

32 A I read all of the, I'm pretty sure that I did, yes, though I can't tell you exactly which ones

33 that I read.

34 Q No.

1 A Other than as indicated in my report.

2 A No, of course. You read the Colt response, did you?

3 A To be honest, I can't remember whether I read the Colt response back in — if I've said
4 somewhere that I did, then I did. But if I haven't said somewhere that I did, then probably
5 I didn't.

6 Q I do not think your report —

7 A Indicates precisely whether I read that.

8 Q Your reading, for understandable reasons, because there are a lot of materials. But I just
9 wanted to understand the scope of the materials that you reviewed. That is very helpful.
10 And a second question — you have obviously helped to prepare this report and I know that
11 you are also instructed by Verizon and Vodafone in relation to the parallel price control
12 appeal, that is right, is it not? Yes. Have you, or those who worked with you on the report,
13 then done any other work for Colt or for any of the supporting interveners?

14 A I haven't ever done anything for Colt. I have done other work for, I believe Talk Talk is
15 one of the interveners and I have done projects for Talk Talk that relate to issues around
16 cost of capital analysis. I have worked for them for some years.

17 Q Understood, but nothing in relation to leased lines.

18 A No

19 Q No, that is very helpful, thank you. Well, let me turn then to the substance. And let us
20 begin with the question of presumptions which has occupied a fair amount of space in the
21 expert evidence. Your position is that there is a general preference for promoting
22 competition at the deepest level that is efficient and sustainable. That is right, is it not?

23 A Correct.

24 Q You do not maintain that this general preference is universally applicable.

25 A Absolutely not.

26 Q You accept that in a specific case it might be defeated by some other principle or some
27 practical details.

28 A I agree, yes.

29 Q It is therefore not your position that in all cases economic theory favours regulation as far as
30 possible upstream.

31 A Well, as far as possible, it depends what you mean by "as far as possible". Sometimes "as
32 far as possible" might mean as far as is practicable and effective and sustainable. But apart
33 from, subject to those qualifications I agree with —

1 Q So, yes, the “as far as possible” might include the specific details and the other principle
2 that

3 A ... but in general what you are saying is right.

4 Q Yes, very helpful, so it will depend then the circumstances and on what is efficient and
5 sustainable in a given case.

6 A I agree, yes.

7 Q And that needs to be assessed on a case by case basis.

8 A Of course one needs to come to a judgment in each individual case, that is correct.

9 Q So let us now turn then to consider the assessment that Ofcom undertook in this case.
10 I would like to begin with the nearly circular argument if I may.

11 A Yes.

12 Q So you say that Ofcom’s rejection of passive remedies rests on several assumptions, one of
13 which is that BT’s recovering different common costs from different bandwidths is
14 advantageous.

15 A Ofcom appears to indicate that that is one of, “its main concerns”, I think, as Mr. Culham
16 puts it.

17 Q Yes, and another assumption that goes to make up this near circularity argument is that in a
18 passive, another market assumption of Ofcom’s I should say, is that in a passive access
19 market prices would be uniform which would be inconsistent with BT’s differentiated
20 common cost recovery downstream.

21 A Yes.

22 Q And you say, I am really just sketching out the argument now, so that we have it before
23 coming to detailed questioning on it.

24 A Indeed.

25 Q You say it follows that Ofcom must be assuming that in a competitive or contestable market
26 for active access products, no passive access market would exist.

27 A Yes.

28 Q And if no passive access market would exist in a competitive or contestable market, the
29 normal justification for mandating passive access would not exist either.

30 A That’s right, yes.

31 Q And in other words, your argument is that Ofcom’s rejection of passive remedies follows
32 from the assumptions that it makes.

33 A That it follows nearly automatically.

34 Q Nearly.

1 A I would say that its assumptions are almost the same thing as its rejection.

2 Q Yes. Not quite the same, though.

3 A No.

4 Q You say you accept that the argument is not circular.

5 A No.

6 Q And that is because there may be other reasons for mandating passive access,
7 notwithstanding the conclusion that in a competitive market place for active access, there
8 would be no passive access market.

9 A That's right.

10 Q Yes, and you give the example of passive access facilitating dynamic competition
11 innovation.

12 A Yes.

13 Q Yes.

14 A So, to unpack the point a little, so you might think that the ideal that the regulator has in
15 mind, I mean, after all, regulation is a dynamic process in itself, you do not just regulate the
16 world as it is, you have some sense that you are going somewhere, trying to promote more
17 and more competition over time, even if you did not think that where you were going would
18 involve a passive remedy, you might think that between here and there I wanted to shake
19 things up a bit by introducing passive access temporarily, even though over the longer term
20 I might eventually get rid of it.

21 Q Yes.

22 A So we could have, even if I didn't think it would exist ultimately, I might think it might
23 exist at an intermediate stage. And that's the sort of, the point about the near circularity.

24 Q Yes. And you are aware that Ofcom considered whether the introduction of passive
25 remedies would facilitate innovation.

26 A Yes.

27 Q And it took account of the fact that imposing passive remedies could provide more scope
28 for product innovation in some cases.

29 A I agree, yes. In fact I think that was the point upon which the expert evidence converged
30 quite a lot as well.

31 Q So, and you would agree that this part of the analysis is not circular, there is no circularity
32 about that consideration of dynamic benefits.

33 A Oh of course it is relevant to consider the dynamic benefits.

1 Q That is very helpful. So, let us now turn to Ofcom's first assumptional conclusion. That is
2 the conclusion that, allowing BT to discriminate in its pricing at the active or retail level is
3 likely to result in more efficient pricing than if Ofcom were to set the prices of all active
4 products directly. Now you are aware, because I know that you have looked at the price
5 control side of matters as well, that this was the basis on which Ofcom designed the price
6 control for active products, it applied a price control generally to a basket of products.

7 A Yes.

8 Q But allowed BT flexibility in the pricing of individual products.

9 A Agreed. Yes.

10 Q So that was really, it was a reasoned regulatory decision, it was not — I do not want to
11 quibble over semantics, but just the assumption is, you did not mean anything pejorative by
12 that description of it. It was —

13 A So can you point me to where I use the term “assumption?”

14 Q Yes, of course. In your second statement if one looks at the summary of the near-circular
15 case, it is 4.4.2. Ofcom proceeds from an assumption that BT's recovering common costs
16 for different bandwidths is advantageous.

17 A Four point —

18 Q It is on p.7, this is a separate —

19 A Four point, I apologise, 4.4.2:
20 “Ofcom proceeds from an assumption that BT's recovering different common costs
21 from different bandwidths is advantageous and the undermining of this would be a
22 sufficient reason for passive access to be unattractive”.

23 Q Yes, I was not criticising your terminology. I just wanted to make clear that that, your use
24 of the term “assumption” is not a suggestion that there was no reasoning.

25 A I am assuming, I'm saying that they're assuming two things, both that it is advantageous to
26 maintain the bandwidth gradient and that the undermining of it will be sufficient reason for
27 passive access to be unattractive. Yes, so they are assuming the two things together.

28 Q But taking the first part, it was a reasoned regulatory conclusion.

29 A Well I'm not criticising their use of a baskets approach rather than the regulating the initial
30 prices.

31 Q That is very helpful. That is all I wanted to ask, thank you. And there is nothing inherently
32 circular or question begging about that part of the analysis, it is an approach that regulators
33 take.

1 A Yes, well, so, sure, absolutely, so to say I regulate on a basket basis rather than individual
2 products is not circular, it is judgment call.

3 Q Yes. And for your part you accept that price discrimination can be socially optimal and in
4 many markets is so.

5 A Absolutely.

6 Q Yes, and you accept that when price discrimination allows output to be increased, the sum
7 of consumer and producer surplus may increase creating a potential welfare gain.

8 A That's the classic, one of the classic cases to be considered to be advantageous.

9 Q Yes.

10 A Of course they could be off-setting losses from allowing it as well.

11 Q No, indeed, well I would like to come and explore two of those now, if I may, but before
12 I do so can I just accept, you would also accept that price discrimination may be desirable
13 for other reasons unrelated strictly to economic efficiency.

14 A Of course, social welfare reasons or a massive social policy or—

15 Q Yes, indeed.

16 A Social cohesion, geographic cohesion, various things of that sort.

17 Q Yes indeed, and you are aware that Ofcom's statutory duties indeed include a requirement
18 to have regard to the desirability of encouraging the availability and use of high speed data
19 transfer services throughout the UK.

20 A Well I wasn't aware of that precise set of wording, but I would have had a vague awareness
21 of the general principle that you can —

22 Q Yes.

23 A I will bear in mind that specific set of wording now you have told me.

24 Q But that supplements any strict efficiency-based considerations.

25 A Of course, absolutely, Ofcom isn't obliged only to consider efficiency considerations.

26 Q No, indeed. So, returning to your second statement, I am coming now to the point that you
27 fairly made that price discrimination may not always conduce to efficiency, and there are
28 other circumstances that you identify. It may be helpful just to look that up. At 4.12 of
29 your statement, on p.10 you identify circumstances in which price discrimination has not
30 been considered unproblematic?

31 A That's not a comprehensive list of them, but this is a set of policy areas in which it is
32 sometimes considered problematic. The point that I was referring to before, of course, is
33 the more general point that in many markets in which if there were no intermediate market
34 then price discrimination would be feasible. Nonetheless, an intermediate market does exist

1 and price discrimination isn't feasible, because the efficiency and innovative gains from
2 having the intermediate market outweigh the efficiency gains from not having the
3 intermediate market.

4 Q This goes back to the near bit of your near circularity argument?

5 A No, this is the circularity point, because if you say: "I assume that it must always be good to
6 facilitate price discrimination" – no, let me put the point a little bit differently. If you are
7 saying at the intermediate level the product will be sold, or would be supplied if a market
8 existed at a uniform price and I also think that if that did not exist then the final product will
9 be sold at a differentiated price, then you haven't therefore said it would be more efficient
10 not to have an intermediate market because there are gains from having the intermediate
11 market as well as the losses. The gains would include greater competitive pressures,
12 improved efficiency, greater innovation, better addressing of consumer needs and various
13 other things associated with the existence of the intermediate market.

14 So what I would say with the circularity point is if you are saying at the intermediate level it
15 would be sold at uniform, at the final level it would be sold differentiated, then all you are
16 doing is saying a very familiar feature, a straightforward economic advantage of not having
17 these ----

18 Q The intermediate undercuts the possibility for price discrimination downstream?

19 A Where the intermediate must be sold ----

20 Q Sold at a uniform price, yes?

21 A Absolutely, and that is just a relatively innocent thing. You are not saying very much.

22 Q No, I fully appreciate that, but we have agreed that Ofcom, whatever view you may take
23 about the adequacy of Ofcom's analysis, we have agreed that Ofcom did take into account
24 the dynamic considerations which might favour introducing an intermediate market?

25 A They certainly analyse the dynamic considerations. I think that when they said that the
26 main concern, at least insofar as Mr. Culham's evidence can be taken as exactly Ofcom's
27 position, but if it were the case that you said the sole or dominant consideration is that the
28 bandwidth gradient must be preserved, and any intermediate market that undermined the
29 bandwidth gradient is therefore unattractive. I think that you are assuming too much,
30 because then you are assuming away the possibility that the gains from having the
31 intermediate market outweigh the losses from having the intermediate market. Nobody
32 denies that there are losses from having the intermediate market in principle.

1 Q So your point is then that insofar as Ofcom proceeded simply from the premises that you
2 cannot have differentiated pricing upstream and that downstream differentiated pricing is
3 good, if that was the sole scope of their analysis there would be a circularity to it?

4 A Yes.

5 Q That is very helpful. So, turning then to the considerations that you identify at 4.12. You
6 refer to anti-competitive conduct, exploitation of final customers by a firm with significant
7 power, and also what you might call foreclosure – exclusionary practices?

8 A Yes.

9 Q You are aware, I suppose, that in designing the price controls Ofcom did introduce specific
10 constraints on BT’s pricing flexibility where it considered this was appropriate to protect
11 against anti-competitive conduct?

12 A I am absolutely aware that Ofcom undertook an exercise of trying to say where BT might
13 be dominant, where it might not and it was, of course, alive to the possibility of the pricing
14 being used strategically as, indeed, was submitted in the experts’ evidence as mentioned in
15 the statement. Nevertheless, I still think that another reason why the point about the price
16 discrimination is not as powerful a consideration as one might initially think is because it is
17 very difficult when you observe price discrimination – unless you have some other party
18 there in a similar position that is also price discriminating in a similar way – to say to what
19 extent that price discrimination is really the sort of efficient price discrimination that might
20 exist were there another price competitor also price discriminating with a similar business
21 model, and to what extent it reflects either inefficient cross-subsidies of various sorts, that
22 the firm might not even be aware that it was engaged in, or various kinds of anti-
23 competitive behaviour which may or may not even be conscious on the part of the entity
24 that is doing this. The point that I was making here is that price discrimination is not
25 usually considered to be unproblematic. There are some gains from it but one should be
26 aware of the potential downsides as well as the upsides, and part of my point, as I say, was
27 to say: “Okay, it’s a consideration”, I am not denying that it is a consideration that you can
28 have some efficiency gain, that is a standard welfare economics result. But, nonetheless,
29 there are offsetting considerations which say that you should not considerate unproblematic.

30 Q To be clear though not only in assessing SMP, market power, which is obviously the first
31 stage of any assessment in the *ex ante* framework, we are also at the stage of designing the
32 remedies. Ofcom did have in mind anti-competitive concerns, and it designed the price
33 controls, the various subcaps in the baskets, and rules against margin squeeze, with an eye

1 on the scope for BT to use its pricing flexibility at the downstream level in ways which
2 might exclude particular rivals?

3 A Of course, but I also indicated here. It can be difficult to know what you do not know, so it
4 is possible that there are things in there which are not visible to a regulator, so you could
5 just miss anti-competitive behaviour, particularly if it wasn't something that was
6 particularly conscious. It could also be that things might evolve in the future. So one of the
7 potential advantages of passive access would be that it would make it harder for someone -
8 anti-competitive behaviour to turn up later, and that would reduce therefore the burden on
9 Ofcom or the burden on the market of identifying the evolution of the markets in their anti-
10 competitive direction.

11 Q Let me take it in stages. You fairly acknowledge in your report that you are not aware at
12 present of any outstanding formal allegation of anti-competitive conduct. For the transcript,
13 the reference is 4.34, but I do not think we need to turn it up. If problems did arise, were
14 identified in the future, you are aware that Ofcom is now required to conduct a market
15 review every three years, absent exceptional circumstances, and problems could be
16 identified and dealt with at a later stage?

17 A It's got to be better. At least it has to be a legitimate consideration that if the competitive
18 processes mean that it's more difficult to exploit a dominant position, then it is better to
19 have a competitive solution than that of a regulatory solution. That doesn't seem to me to
20 be contentious.

21 Q You began by saying it has got to be better, and you modified your response to, "It is a
22 legitimate consideration". When you say it has got to be better, you accept, I think, that one
23 looks at this in the round, but one balances certain benefits of price discrimination against
24 certain benefits of another model of regulation?

25 A Of course, but I must focus on the narrow point that if we have two types of situation, one
26 in which we have sufficient competition that the question of abusive dominance never
27 arises, and we have a second situation where we monitor and make sure that their
28 dominance isn't being abused, I would have thought that the first situation would be fairly
29 universally acknowledged to be better.

30 Q To be clear, that is taking the one single consideration ----

31 A It is a narrow consideration, absolutely.

32 Q -- of excluding the scope of exclusionary behaviour. It is not part of any wider calculus?

33 A No, I'm just focusing on that narrow point.

1 Q Yes, that is very helpful. Let me turn to exploitation of market power which you also
2 identify here. Price control operates to constrain the scope for exploitative pricing on BT's
3 part.

4 A Sure.

5 Q Can we therefore exclude this aspect of this particular countervailing concern?

6 A I don't think we can absolutely in the power for the point. So where you grant flexibility
7 there must in principle be the possibility that the flexibility in a basket is used by the
8 incumbent, by the regulated entity, to charge at below what would otherwise be a
9 competitive entry price for some products, cross-subsiding by using its market power to
10 charge above that level in respect of other products. I don't think that the fact that there is a
11 price control over a basket means that you couldn't believe that there would be some risk of
12 anti-competitive behaviour in respect of individual products.

13 Q To be clear, the point that you have just made is premised on the assumption that these are
14 cross-subsidies and not simply an allocation of common costs to products which are priced
15 above incremental costs?

16 A Absolutely, but it can be very difficult to observe one as opposed to the other.

17 Q Turning back a page on your second statement to 4.7, and I think this goes to the point that
18 you were just making about practicality, this explains the Ramsey allocative ideal, if you
19 remember. At the end of the paragraph you observe in passing that it would be inherently
20 difficult in practice for a regulator to determine to what extent any pricing scheme conforms
21 to a Ramsey ideal, not least because it is rare for the Ramsey ideal to be approached other
22 than highly imperfectly, even in highly competitive markets. Am I right in thinking that
23 that is the point that you were just making, one of the points about a difficulty of testing the
24 efficiency of the prices?

25 A Exactly. It can be very difficult to tell whether what's happening is that you have got some
26 kind of cross-subsidy, as opposed to things being allocated in a more efficient way.

27 Q And your point here is a practical one of the difficulties of observation rather than any
28 principled objection to the idea of Ramsey pricing as a means of achieving allocative
29 efficiency?

30 A Absolutely, yes.

31 Q For your part, and no criticism is intended by this, it would be fair to say that you do not
32 offer any specific analysis outside the scope of your evidence to show that BT's price
33 discrimination is not more efficient than pricing based on, say, for example, average
34 common costs recovery would be?

1 A In terms of its structure, absolutely, yes.

2 Q Let us turn to the second of Ofcom's assumptions to which you refer, namely that passive
3 access would not support price discrimination. Your position is that the correct starting
4 point should be suspicion that if a passive access market existed price discrimination would
5 not exist?

6 A Yes.

7 Q And that is because, unlike the hair cut example, which was very helpful for a non-
8 economist because I understood it, there is no intrinsic difficulty in reselling the ongoing
9 use of duct space?

10 A Yes.

11 Q It is not like having somebody in the barber's chair where you can easily ensure that you are
12 providing this service either to a child or an OAP or to someone in between and fix your
13 pricing accordingly?

14 A Correct.

15 Q There is, therefore, nothing intrinsic about the product that would stop arbitrage?

16 A Yes.

17 Q So your starting point then would be exactly the assumption that Ofcom started from?

18 A I think that that is the most natural starting point. I don't think you could guarantee that for
19 the reasons which I set out, but I do think that that is - yes, I agree that that is the - I'm not
20 criticising that as a way of thinking about things. My only criticism of that would be if you
21 place too much weight upon it.

22 Q When you say what you come to later, that is the monitoring and control mechanisms you
23 identify in section 5 which I will come to in a moment, if I may, but let us just stick for a
24 moment with the uniform pricing. You say that this was an implicit assumption on Ofcom's
25 part. Ofcom did - and again I do not want to cavil at terminology, but just to be sure that we
26 are on the same page - Ofcom did explicitly proceed on the basis that a single flat rate
27 charge for passive access may need to be set?

28 A Well, they do - in the statement I think they do say that at something like 8.82 or
29 thereabouts. My reference there I think was to the discussion in the expert evidence. I may
30 have slightly ----

31 Q I do not think, to be honest, it is material to your expert opinion, it was just a point of
32 terminology.

33 A What I meant was that in the discussion, in the exchanges that we had had I felt that
34 Mr. Lazarus on behalf of BT had been more explicit in saying you could only have - this

1 was the only way of doing things. Even in 8.82 of the BCMR, I think they say something
2 like it may be that you end up with one possible passive access, as far as I recall.

3 Q Very good. Let me now turn to an assumption that you make, if I may. You say that the
4 normal reason for granting an access remedy is that the regulator believes that in the ideal
5 architecture for the industry there would be competition or contestability at that level. As a
6 regulator, one is addressing a bottleneck asset - you would accept that - in the form of BT's
7 network. We are trying to decide how to deal with something that is not easily replicable, at
8 least across its whole topography, and therefore you have market power on BT's part?

9 A I'm not 100 per cent sure that that is the way I would put it to begin with.

10 Q That is the nub of the economic problem, is it not? The reason why we have a lack of
11 competition here is because there is an asset which is not readily duplicable and which other
12 people need access to?

13 A At least for now, yes.

14 Q At least for now.

15 A Absolutely.

16 Q As a result of its non-duplicability, at least for now, there is not a competitive market for
17 that asset at any level, either the passive or the active level. So you might think that what
18 was going on was there were a lot of trenches dug in the ground and that it was not going to
19 be practicable or attractive to have two sets of trenches dug in the ground, so it would be a
20 natural state, at least for the moment, for there to be one set of trenches. It does not mean
21 that you have to accept that that is going to be the case forever. It could be that you end up
22 with stuff that goes through the air, competing with stuff that goes through the ground?

23 A Yes.

24 Or a number of other technological developments. It does not seem to me that any regulator
25 should ever despair of the possibility of infrastructure access arising at some point in the
26 future?

27 Q No indeed. In this sector there has obviously been massive technological change which has
28 led to rival methods of transmitting data, carrying voice telephony, and also of course at
29 various times when capital is more readily available than at other times, there has been quite
30 a lot of digging up the roads as well.

31 I was not suggesting that all bits are non-duplicable. But where they cease to be non-duplicable
32 one sees a competitive market introduced and a removal of the SMP finding, as in the case
33 of WECLA in this context. But where we are dealing with those stubborn bottlenecks in
34 relation to which infrastructure based or rival technological solutions have not been found,

1 the regulator's job is to select from a range of available remedies in order to deal with the
2 market power.

3 A That is not really quite how I would put it. I think that one of the things that it is trying to
4 do when it considers something like an access remedy is to facilitate competition. So I
5 think that it's not just a matter of managing the existence of market power, but one of the
6 things the regulator is trying to do is to undermine market power, so that there is more
7 competition in the future.

8 Q So you are saying that one would need to do a cost benefit analysis of the different
9 regulatory options, bearing in mind the desirability of curtailing regulation where possible
10 in the future?

11 A I think what I'm saying there in the discussion about what might be your ideal competitive
12 architecture is slightly different. I think the way of thinking about this is it is a mistake for a
13 regulator just to think that its job is to manage the status quo. A regulator should,
14 particularly a regulator like Ofcom with a duty to promote competition, have in mind
15 somewhere that it is going. I think that regulation is intrinsically in theory illogical. Where
16 it is going might change over time with evolving tastes or evolving technologies, things of
17 that sort, but it should have some sense that it is going somewhere. That doesn't mean it
18 has to get there tomorrow, because it might not be practical. Part of where it is going - and
19 also, in addition to the technologies, as it were the IT or that kind of technology, there may
20 be evolution of regulatory technologies. So we might have different ways of thinking about
21 the process of enhancing competition. Nonetheless, at any one point in time, subject to all
22 of these sorts of constraints, we should have in mind some place that we're trying to get to.
23 What I'm talking about when I talk about an ideal competitive architecture, it is all a bit of
24 fancy words, but I am trying to avoid using words like regulated products so that you do not
25 think that I am talking about regulating specific prices. It is right to consider the
26 combination which markets is there competition in, what is the set of remedies, that kind of
27 thing.

28 Q It is the regulator standing back and formulating, looking at the big picture, a view of where
29 it wants to get to in this sector?

30 A Absolutely, and that surely is the point of reviews of things like whether you should
31 introduce different kinds of remedies.

32 Q Yes indeed, bearing in mind a number of different considerations which need to be balanced
33 and traded off against one another?

34 A Yes.

1 Q Thank you. Let us turn, then, to the very specific advantages and disadvantages which
2 Ofcom took into account in deciding whether to introduce passive remedies. I would like to
3 start, if I may, with the potential disadvantages. As we have discussed, Ofcom proceeded
4 on the basis that prices for passive access might be uniform and Ofcom considered that new
5 entrants would focus on the downstream active services where BT recovers more common
6 costs?

7 A Yes.

8 Q Those are high banded products, and products supplied in high usage geographic areas?

9 A I am informed that is what they said, yes.

10 Q Assuming uniform prices at the passive level, you accept that the result would be to disrupt
11 downstream price differentiation.

12 A Correct.

13 Q That is not contentious. So you accept that the bandwidth gradient would be difficult to
14 sustain and geographical common pricing would be difficult to sustain?

15 A It would certainly be difficult to sustain if you've got very large amounts of passive entry.
16 If you only have very small amounts of passive entry, then it might be possible to sustain it.

17 Q The levels of entry you saw would depend upon the uniform price at which the entry was
18 set?

19 A They would depend on that, but they might also depend on technological or other sorts of
20 business environment features, but yes by and large, I would agree.

21 Q Ofcom had a number of concerns in relation to this, did it not? One was inefficient entry.
22 You accept that your first report does not really deal with the point that Ofcom had in mind,
23 as you now understand it?

24 A Correct. My reading of the --

25 Q Yes, of course.

26 A -- whatever they were, ... and so on in the original statements. I think now with it clarified
27 by the expert statements it's clearer to me now what was being referred to, than it was at the
28 time I wrote this report.

29 Q That is very helpful. If there is an inconsistency between the pricing of active and passive
30 remedies, entry could be induced where the incremental costs of BT in serving the demand
31 would be lower than the incremental costs of the entrant, but the passive price still allowed
32 the entrant to undercut BT's prices. It would not necessarily be the case, but it might be the
33 case?

34 A Sorry, say again?

1 Q Sorry, it is a long and convoluted sentence. I will take it in stages. If you had pricing of
2 active and passive remedies in particular, the inconsistency point, you had a bandwidth
3 gradient for one and differential pricing for the other, flat rate for the other you might see
4 entry where the incremental costs of BT in serving the demand for a particular customer
5 would be lower than the incremental costs of the entrant. Would you accept that that was
6 the case?

7 A The incremental costs of -- I'm not sure that that's right. What incremental costs? Do you
8 mean the incremental costs between the passive and the active?

9 Q No, I mean the incremental costs of supplying the service.

10 A I'm just trying to think whether that's -- I would have thought that the bandwidth gradient
11 was associated with a differential (this may not be the only thing, but the thing which is
12 most likely here would be differential) recovery of common costs, particularly, say, the
13 costs of the duct and things of that sort. So then in that case, the incremental costs, as it
14 were, of having actually got the duct and so on in place, the incremental costs of the actual
15 delivery for BT, I don't see why they would be less than those of the entrant - unless I'm
16 missing something.

17 Q No, you have got the common costs recovery portion at the downstream level which is
18 heaped on to the specific costs associated with running and serving a wire between two
19 points, the leased line if you like. At the active level, with the differential, that is added on.
20 We have agreed that new entrants would focus on that customer because of all of those
21 heaped common costs which are disproportionately loaded on to, say, the high bandwidth
22 customer but are averaged at the passive level.

23 A Oh, I think I see what you're saying now. So you're saying that if we take it as given that
24 BT is recovering its common costs in this differentiated way then a product which it sold at
25 a lower level of incremental cost might be more expensive than the equivalent product
26 provided by the passive access, even if the passive access seems to have a higher cost?

27 Q Yes. Thank you. That was the only point. I am grateful to you for clarifying my thinking.
28 You accept that this might give rise to some inefficiencies but you say that these must be
29 balanced against dynamic gains.

30 A Yes.

31 Q Now, a second concern for Ofcom was price rises for customers of lower bandwidth
32 services and users outside the dense urban areas where the network is most intensively used.
33 You would accept that if there were a price differential and there were at the downstream
34 level but not the upstream level and they were arbitrage-based entry in consequence of that

1 mis-match, that BT might need to increase its prices for those customers from which it
2 currently recovers a smaller proportion of its common costs.

3 A That's, well, just to clarify a point, you are saying that I have some lower bandwidths and
4 some higher band with levels.

5 Q Yes.

6 A So I think the geography sounds like a red herring at the moment, but just on the general
7 point —

8 Q Let us deal with bandwidth gradient and then turn to geography and take our turn.

9 A Yes, so if we have — absolutely, sir, if what is happening is that you are tending to
10 undermine the higher bandwidth common costs recovery, then for a given total cost
11 recovery BT will have to raise its prices on the lower bandwidth products. So you tend to
12 get some evening out.

13 Q Yes.

14 A And if you have enough passive access, you would eliminate the bandwidth gradient
15 altogether.

16 Q And now let us take the geographical situation.

17 A Yes.

18 Q There are some bits of the network which are intensively used, four or five customers, let us
19 say, in a simplified example by comparison with one customer in another area. And there
20 are economies of scale associated with serving four or five customers by comparison with
21 serving one customer on another bit of the network.

22 A Yes.

23 Q Let us just assume that network prices are otherwise constant across different geographies
24 for a moment, for the purposes of this example.

25 A Okay.

26 Q You would accept, would you not, that there is an implicit differentiation of common cost
27 recovery by BT if it charges the same price to all five customers, the four customers on the
28 intensively used line and the one customer on the non-intensively used line.

29 A That may well be so insofar as the intensive area does not also correspond, the intensively
30 used does not also correspond to some high cost area, because it could be, it's not unknown,
31 for example, for land to be more expensive in city centres than in rural areas as well as —

32 Q Yes, but let us keep it simple for the moment, and assume in this worked example that the
33 geographical costs are constant.

34 A Sure.

1 Q In those circumstances, insofar as you would see the same phenomenon of arbitrage based
2 entry in relation to the intensively used bit of the network in the same way that you would
3 with differences of bandwidth, because there are differences in the level of common cost
4 recovery which makes the customers in the high used bits more attractive, because they are
5 priced at higher mark up over incremental costs.

6 A Well, I guess I've got two comments on that. One is that it's, although I don't disagree, that
7 it's not clear to me that this is an additional issue in that, for example, it could be that the
8 highest bandwidth products are also the most geographically intensively used ones, so it
9 could be that the process of addressing the high bandwidth one issue automatically
10 addresses the geographic issue.

11 Q Well, that might add a layer of complexity, might it not, but laying that on one side —

12 A And the second thing that I would say is, whereas in the case of the duct space in a
13 particular geography, it seems to me to be most natural to assume it would be efficient for it
14 to be sold at a uniform price. I think that that is much less plausible when it comes to
15 different geographies, I would have thought that it was most natural to assume that bits of
16 space — what we're talking about here is some bits of land, a trench or something — would
17 have a different price in different parts of the country. And I don't really see why it would
18 be so impractical as in fact I understand it to have been done in other countries, that you
19 might zone countries in various ways, have areas around the CBD or the city fringe or rural
20 areas.

21 Q Yes.

22 A Or things of that sort. You can have a small and tractable number of areas and your passive
23 access charge could, or you could have a premium to the general passive access charge
24 depending on geography, and so whereas I think the natural thing, and it is at least arguable,
25 that you would have a uniform price as the natural state in respect of passive access for a
26 given geography, it seems much less defensible to me to think that that would be efficient
27 for different geographies.

28 Q So one would end up, then with geographical, an efficient solution might well involve
29 geographical de-averaging with different prices being charged in different localities.

30 A Yes, or a price premium of some sort, yes.

31 Q Thank you. And just on the subject of efficiency there is, insofar as prices rise for particular
32 customers and they are priced out of the market, there is some consequential welfare loss
33 which you would have to factor into your welfare equation. Would you accept that?

1 A Absolutely. I mean this is why the Ramsey price type scheme is attractive. It's because you
2 find those who, there are some parties where their marginal willingness to pay is above your
3 marginal willingness to provide, and whereas if you have to charge at a uniform price you
4 cannot do that in the same way.

5 Q Yes. Now Ofcom was also concerned about inefficient duplication of infrastructure.
6 Specifically various assets would be duplicated by comparison with a situation where active
7 remedies were used instead. Now, you accept, do you not, that there would be such costs of
8 duplication?

9 A Well I accept that there might be duplication. I don't think it's a particularly interesting
10 consideration in that it seems to me that you get, that whilst you get duplication in many
11 types of market processes, I think I give the example of duplications of accounting systems
12 and payroll systems, you could imagine having one accounting system for the entire country
13 or something of that sort, nonetheless the process of duplication very often in fact typically
14 increases the efficiency, increases efficiency in the very same thing, increases efficiency
15 elsewhere. So, it's not the natural thing to assume that the process of duplication results in
16 a net loss because you get two particular gains from the duplication, namely the more
17 efficient use of the assets and the more efficient addressing of consumer needs.

18 Q So again this is just part of the balance if you like. Your point is that the costs have to be
19 balanced against dynamic benefits of competition among other things, and efficient use of
20 the assets.

21 A Yes, that's right. It's not only dynamic benefits I think in this case.

22 Q But you do not claim that they would necessarily be offset by such factors.

23 A No, of course.

24 Q No.

25 A Not every business has only five people in it, right?

26 Q Yes.

27 A Sometimes there are gains from having larger businesses.

28 Q Yes, so you do not say that the costs should simply be disregarded.

29 A No.

30 Q In other words, this is another complex trade off requiring regulatory judgment.

31 A Absolutely. In fact perhaps even some cost benefit analysis, preferably quantitative.

32 Q Now on that, your position is that neither you nor Ofcom has done such an analysis.

33 A Correct.

1 Q Now, you would accept that Ofcom identified various benefits and detriments of passive
2 access as it saw them.

3 A Yes.

4 Q And Ofcom made a judgment about them.

5 A Yes.

6 Q What you mean, then, is that Ofcom did not perform a quantified analysis, is that right?

7 A Not only that, because of course many times it's not, you can't quantify absolutely
8 everything, so, in practical policy making you are always using some element of judgment.
9 But I do feel that Ofcom hasn't really told us why it thinks that the benefits here are less
10 than the costs, yes. It seems to me that there's quite a lot of assertion that things are
11 unattractive when I'm not very — I don't feel like Ofcom has exposed to us, certainly not in
12 the statement maybe, maybe it is exposed to us in more detail, who knows, in the expert
13 witness and things. I guess that's for the Tribunal to decide. But it doesn't seem to me that
14 they've exposed to us that much of what their reasoning really was. So my point is that, my
15 point here, is that you don't always, I don't claim that any practical policy maker always has
16 to have a precise numerical estimate of all of the costs and all the benefits and all the risks
17 around the costs and all the weightings which they want to have. It's obviously more
18 attractive to have more quantification rather than less if you can get it. But it should at least
19 give us some sense of why it thinks that the costs outweigh the benefits, or vice versa. You
20 shouldn't just say that you think that they do.

21 Q Yes. "If you can", I just want to explore those words: "if you can" – "better to have
22 quantitative assessment if you can." You would accept that there will be cases where it is
23 hard to quantify, hard to attach a number?

24 A I do. On the other hand I am not sure that the case of price discrimination is really one of
25 them in that I think there are quite well known techniques for estimating what the welfare
26 gains are associated with price discrimination, and I'm sure you'd find some earnest
27 consultants that you could hire to look at the question.

28 Q You are not advertising your services! (Laughter) One of the factors that would need to be
29 taken into account and weighed in the balance would be the idea of people coming along
30 with innovative developments. Do you suggest that that would be quantifiable easily?

31 A I don't think you'd be able to quantify the gains from that with any high degree of precision.
32 People do produce notional quantitative estimates of what gains from innovation there
33 might be. Hausman, for example, has done some work on this which Ofcom has placed

1 some weight upon in the past. People do try to estimate what some of the potential gains are
2 from innovation foregone.

3 Q But is it a fair criticism that those quantifications are heavily driven by the assumptions that
4 you put into them?

5 A All sensible policy making quantifications are driven by assumptions. That does not mean
6 that they are invalid because one of the things that you are doing is exposing your
7 reasoning processes. You tell people what your assumptions are and then people can work
8 out whether they agree or disagree, they can challenge them, they can improve them, so that
9 saying that any answer it produces depends to some extent both on its internal structure and
10 on the quantitative assumptions you put in is, I think, relatively uncontroversial – ‘garbage
11 in/garbage out’ as the saying goes is as old as the hills. Just because you can say “garbage
12 in/garbage out” does not mean that no computer ever produces a good answer.

13 Q No, we are talking a matter of degree between two extremes: garbage in/garbage out on the
14 one hand and other circumstances in which it is possible to arrive at very precise
15 quantification?

16 A Anybody can always disagree with a regulatory decision, that is why we have politicians, is
17 it not?

18 Q And experts and lawyers?

19 A And experts and so on. But just because you could disagree does not mean that we cannot
20 come to a reasoned judgment about what is right and wrong.

21 Q You did not allege in your first expert report that Ofcom’s Decision was flawed by reason
22 of a lack of quantification, did you?

23 A I don’t recall raising the question of quantification in my first report.

24 Q Why was that?

25 A My raising quantification in my second report responded to the statement in Culham’s first
26 report that the correct mode of analysis would be cost benefits analysis. So I was pointing
27 out that if you think that cost benefit analysis is the way to do things then it might be nice to
28 know a bit more about what the costs and the benefits were.

29 Q But we have agreed that the statement did identify benefits and detriments, and you were
30 opining upon it in your first report. I am just surprised, if this was a serious consideration,
31 that you did not identify it as a criticism then?

32 A I think, in some abstract sense, you are always going to be thinking about weighing up costs
33 and benefits, but at the time of the first report it seemed to me that the central considerations
34 were those associated with competitive processes, dynamic features, things that would be

1 intrinsically very difficult to quantify. The issue of putting it in terms of cost benefit
2 analysis was something that was subsequently then raised by Mr. Culham as his way of
3 thinking about it. He said that was the way to do things and I was trying to get inside his
4 way of doing things and say: “Okay, if cost benefit analysis is his, then ----”

5 Q So your argument is addressed to Mr. Culham’s statement?

6 A Yes, really, yes.

7 Q Let me now turn to the other main limb of your second statement – there has obviously been
8 a newswire development, but I doubt it will be relevant to the leased lines market.

9 A Who knows?

10 Q Let us now turn to the other main limb of your second statement in which you consider
11 whether uniform pricing of passive access could, in fact, be avoided. You offer two ways
12 of doing this. The first is different prices for different purposes, and the second is a high
13 flat rate, and I would like to explore those in turn, if I may. Starting with differentiated
14 pricing, Ofcom referred to this in the statement and doubted whether it would be
15 practicable?

16 A Yes.

17 Q No one, during the consultation process responded by saying Ofcom’s concerns could be
18 addressed through differential pricing at the passive level ----

19 A I don’t think so, I think Fujitsu may well have said that that could be done.

20 MR BEAL: I thought, for a moment that may be a confidential reference, but actually, thinking
21 about it, Fujitsu’s response to the CFI was open, and it is available on Ofcom’s website, so I
22 apologise. Like the newsflash, I was inappropriate.

23 A The reference I made was definitely to a non-redacted part at 8.112 I think.

24 Q I do not think there is need to redact anything from the transcript.

25 A I think it’s at 8.112 if I recall correctly.

26 Q We will come back to that, perhaps, but can I ask you to turn up 5.10 of your second
27 statement.

28 THE CHAIRMAN: Just a moment, Dr. Lilico is quite correct, it is 8.112 and it is Fujitsu.

29 MR. HOLMES: It is Fujitsu, okay, that is very helpful. (To the witness): You set out four bases
30 on which one might query Ofcom’s conclusion that differentiated pricing and passive access
31 is impracticable. You fairly frame these as queries, so they are questions. You are not
32 saying definitively that the conclusion is wrong, is that right?

33 A I am saying it’s questionable, yes. That’s right, yes.

1 Q Your first query is whether it might be possible to dispense with monitoring abuse by
2 Ofcom, and to have BT impose a contractual obligation as to use and to do the monitoring
3 itself?

4 A Yes.

5 Q So what you are proposing here is the payment of money in the event of breach, whether or
6 not the breach has caused loss in that amount to BT for the purpose of deterring breach, is
7 that right?

8 A Well, I don't know whether I had in mind that that would be part of the contract itself, or
9 whether that would be something which then courts or others subsequently would do. The
10 payments would have to be sufficient, whatever payments occurred in the event of a breach,
11 or other sorts of things, loss of reputation, that kind of thing, would have to be adequate to
12 deter it in cases where it was not spotted, because I am not claiming here that you would
13 spot absolutely every ----

14 Q Yes, BT's loss might be relatively small fry by comparison with all of the cases that went
15 undetected?

16 A Well, I don't know how many would be undetected, but when you have contracts if there is
17 a contract violation then there are consequences of contract violations.

18 Q In principle, BT's loss might not be enough to deter the conduct in a given case?

19 A Yes, it might not. But, as I say, there are other kinds of things. In other settings where you
20 have a contract violation it's not usually the case that people enter into a contract and then
21 the only consideration they have of whether they violated it is whether they wanted to pay
22 the costs associated with the penalties associated with that. There are other things which
23 they bear – other people won't make a deal with them in the future ----

24 Q Honour among CPs.

25 A I am just saying there would have to be somehow enough consequences to the violation of
26 the contract to deter violating the contract in cases which were not spotted.

27 Q Under this model competitors would have to tell BT what they were planning to use the
28 service for, is that right?

29 A Yes.

30 Q And if we are concerned about geographical issues they would have to tell BT whenever
31 they added another customer to ensure that prices reflected intensity of usage on a given bit
32 of the network?

33 A I suppose so insofar as geographical issues were an additive to the other issues. As I said
34 before, it might be that the geographic issue was already solved by the bandwidth

1 differential issue. I suppose if it were an additional issue then you might need to do that.
2 As I say, the geographic thing I would have thought a more elegant solution in terms of the
3 geographic thing would be to ... charges.

4 Q Yes, you would see prices rise for some areas of the country and maybe fall for others?
5 A Yes, I guess so. On the other hand, see the ways in which common costs were recovered,
6 other kinds of costs were recovered, change a little. I agree, the general mood would be that
7 some de-averaging would be a consequence.

8 Q Would you accept that there might be concerns with competitors being required to share
9 commercially sensitive information of this nature, a big company being given information
10 about plucking a new entrant and the services being provided, the number of customers in a
11 given area, where they were recruiting new customers?

12 A I'm not sure it's "plucking", some of these big firms. I don't think it's unheard of for
13 people to sell things on the basis of some agreement of what they will then be used for.
14 That doesn't seem to me to be that strange a thing to happen.

15 Q Do you accept, at least in principle, that there may be a competition concern in so far as the
16 person selling, you have to form a downstream market ----

17 A So you're telling them what you're going to use it for, so you have given ----

18 Q You are giving him some transparency about a competitor's operations?
19 A Absolutely, so there might be - of course there would be some consequences of that.

20 Q Just to be clear, your contract model is one that is devised on the basis of economic
21 expertise and common sense of what is achievable?

22 A Absolutely.

23 Q It is not based on any experience that you personally have of negotiating contracts of this
24 nature?

25 A Absolutely none.

26 Q I know the answer to this, but let me just ask it for form: you are not positing any view as
27 to the technical feasibility of monitoring the use to which the fibre is put?

28 A No, I have no technical expertise relevant.

29 Q A contract model might dispense with Ofcom monitoring what use a leased line is put to,
30 but it still depends on BT being able to do so in order to detect and put into place the
31 punitive mechanisms. I think you accept that, do you not?

32 A Yes, but monitoring may not be a technical matter. For example, if you only bought one -
33 let's take a very extreme case. Suppose that I only bought one bandwidth - sorry, I bought

1 something and I said I was only going to supply one bandwidth and then downstream I
2 supplied some different bandwidth, then people could spot that.

3 Q How?

4 A That you'd sold a different bandwidth?

5 Q Yes.

6 A They might find, for example, that one of their customers with a different bandwidth said,
7 "We are now leaving you and going over to, we're switching to somebody else".

8 Q So, subject to non-disclosure agreements between the customer and the CP, there might be
9 some leakage?

10 A Sure, so there would be some possibility of being reported, at least in simple cases. I'm not
11 pretending that this is an entirely trivial question, but the point about people who sell things,
12 keeping an eye on what use is made of them, again I don't think it's that unusual.

13 Q I am not disputing - you mention that BT has an incentive to monitor in the report, and I am
14 not disputing the incentive, but you accept that the incentive would not be relevant in so far
15 as monitoring was not practically possible?

16 A If it's not possible to do, if that's really true that it's not possible to do - I guess my point is,
17 I don't think that whether it's possible to do necessarily depends only on technical
18 questions. That's the only additional point that I was raising. I have no technical expertise
19 as to whether it is technically feasible, but it seems plausible to me that it might be possible
20 in non-technical ways as well.

21 Q So your second query at 5.10.2 is whether differential passive access pricing really needs to
22 be so complex. You would just have different wholesale minus or retail minus prices - it
23 does not much matter how one describes them - reflecting different active product prices?

24 A Sure, you just have a differential. You calculate what is active to passive cost was, and then
25 you just subtract that off whatever BT's active price was on the day.

26 Q This approach again is premised on the monitoring problem being resolved? Any problem
27 of monitoring, you need to know what they are doing in order to be able to price the
28 contract?

29 A Yes.

30 Q It focuses in particular on the type of product being supplied and not the geographical issues
31 on the basis that you think geography should be de-averaged in any event?

32 A Well, that is should be de-averaged, but I think it could be de-averaged, yes.

33 Q So the solution would be to see different prices in different bits of the country and that
34 would take that out of the equation?

1 A Yes. I think that their sole retail price is different in different parts of the country anyway.
2 Yes, I am here focused - this point is focused principally on bandwidth issues rather than
3 geographic issues.

4 Q At 5.10.3, we come to your third solution, whereby a passive access seeker would be
5 obliged to provide the full range of active access products that BT provides at a price no
6 higher than BT sells them. You, yourself, recognise that this perhaps is more speculative -
7 is that right?

8 A Yes, I agree, that's what I say.

9 Q Why is that?

10 A I think that what you're talking about here is a rather grander scheme, rather than just
11 devising specific passes, what you are talking about is a bit of a departure from the way
12 things are normally done in the telecoms sector. Similar things are done in perhaps slightly
13 more distant sectors. For example, in the pharmaceutical sector wholesalers in some
14 countries and pharmacies in other countries are subject to full line obligations, where they
15 have to supply all the medicines. That's the kind of thing which I had in mind. Fujitsu
16 mentions the thought of doing this here in this setting as well. I agree that it's more
17 speculative but it is just one of my list of things that you could imagine thinking about.

18 Q You describe it as a relatively non-burdensome requirement. Would you agree that that is
19 really a matter of commercial rather than economic judgment?

20 A No. What I mean by "relatively non-burdensome" here isn't - it could well be
21 commercially enormously burdensome. What I mean by "non-burdensome" would be
22 relative to the monitoring point. I was imagining that the first two points might involve
23 quite a significant monitoring burden. In the third case, what you are saying is that you
24 have to supply everything.

25 Q So it is relatively non-burdensome in terms of the regulatory infrastructure that is put in
26 place, rather than the obligations that the CP, for example ----

27 A The regulatory infrastructure and also perhaps the infrastructure of the monitoring - not
28 obligations but demands, let's say, upon BT.

29 Q How would you ensure that the access seeker did not then focus on promoting certain
30 services at the expense of others?

31 A I imagine you would do this in much the same way that is done in these other settings, like,
32 as I say, pharmaceuticals. These have a good faith requirement. In the case of
33 pharmaceuticals wholesaling, say, if it always turned out that you delivered a certain kind of
34 medicine late then the regulator might not think that you were really meeting the obligation

1 to provide full life. So if you didn't bother to correct faults, certain bandwidths or
2 something of that sort, then people might get suspicious that you were really delivering the
3 whole thing in good faith. They may well aim to press certain bandwidths more than others,
4 but ----

5 Q But is there not a difference between the - I am thinking of the full line pharmacy that you
6 referred to, the sort of public service of pharmacy provision that you do get in a lot of
7 European states. There is no particular incentive against providing any particular
8 pharmaceutical product, is there?

9 A Other than that it might be - obviously it takes up space on your shelf and it might be more
10 attractive to sell other kinds of ----

11 Q Here, for the arbitrageur entrant, the CP, there is a specific incentive to supply some
12 services but not others?

13 A There is an incentive to supply more of some services than others. I am not clear why you
14 think that there is a disincentive to supply some of the services.

15 Q There is the fact that the profits that they can make on some services are much higher than
16 others. That is why some are incentivised to supply some services but not others?

17 A So what you are saying is that for a given amount of passive access you can purchase a
18 certain amount of ducts or something - I might end up using some of my ducts to sell some
19 things more than others?

20 Q Yes.

21 A Of course, it might be that I would end up - yes, it might well be that I would end up aiming
22 to sell more of some products than others.

23 Q You are assuming here again geographical de-averaging, are you not, or do you require ----

24 A I'm assuming away the significance of the geographical issue. I am focused upon the
25 bandwidth.

26 Q To be clear, to deal with the geographical issue, you would have to require a CP not only to
27 supply the full complement of services, but also to supply them on a national basis?

28 A I agree, I am focused upon the bandwidth issue here. I'm not really thinking about the
29 geographical issue.

30 Q Fourthly, at 5.10.4 you suggest that Ofcom can simply require BT to price on FRAND
31 terms?

32 A Yes.

33 Q This is again premised on monitoring and enforcement not proving insurmountable?

34 A Yes, agreed, yes.

1 Q Your other suggestion is a high flat rate price for passive access. So the idea here is that
2 you norm the prices, you put it against the highest common cost recovering access price?

3 A Yes.

4 Q And you say that this could deal with geography although Mr. Mantzos' worked example is
5 confined to the range of different product uses, is that right?

6 A Yes, so here I'm just picking the highest common cost recovering product. The highest
7 common cost recovering product might be a number of different geographies. So the
8 discussion here doesn't depend upon whether it's bandwidth or geography. It's just
9 whatever's the highest common cost recovering way.

10 Q You do not know that this price, the price that Mr. Mantzos has worked out, would be
11 attractive to any CPs - whether the price is too high to allow competition?

12 A Mr. Mantzos' analysis I don't think was targeted at producing a putative price; it was
13 targeted at seeing whether the method I described could be executed.

14 Q But he did come up with a price, did he not?

15 A Yes, of course, he is doing a worked example and he is showing whether - no, the price, I
16 hadn't formed a view and it hasn't seemed to me to be appropriate to form a view as to how
17 plausible or otherwise that price is. The point about that worked example is only to see
18 whether the data exists to do the thing I have described.

19 Q To do the minus bit?

20 A It could have been that certain of the things that I described you couldn't do in practice, or
21 you could only do them once every five years or something.

22 Q So you do not dispute the point in the Colt reply that the price may be too high to allow
23 competition?

24 A I haven't formed a view on that point at all.

25 Q No indeed. OK, thank you. I think I have no further. I am very grateful. There may be
26 some questions from Mr. Beard or questions in reply from Mr. Beal.

27 THE CHAIRMAN: Mr. Beard?

28 MR. BEARD: No.

29 THE CHAIRMAN: Mr. Beal.

30 Re-examined by Mr. BEAL

31 Q Dr. Lilico, let us see if we can get you done for this evening. Firstly, you were asked about
32 effectively there being an incentive for people who have higher LRIC costs, but I think the
33 assumption must be that they somehow had flexibility on their common costs recovery,

1 which meant that they could somehow pass off their common costs to somebody else,
2 would that be right?

3 A I don't think that was the question I was asked, no. I believe I was asked about a scenario in
4 which BT is charging a high active access price because for a given incremental cost it's
5 recovering a lot of duct costs and so on, and that the amount of duct costs it was recovering
6 was above the passive access price.

7 Q Yes.

8 A So what that would mean is that in principle you could have an entrant where the entrance
9 costs were higher than BT's, but its total price for that banded product was lower than BT's.

10 Q Does that make any assumption about what the common cost recovery for the entrant would
11 be, or are you simply saying the incremental costs charged by the entrant for entry would be
12 lower than a LRIC plus price for BT?

13 A I took the term incremental cost here to be a sort of shorthand for the various costs that that
14 player might have. So it could be, of course, that that player would have costs of its
15 electronic equipment that it put at either end of the wire, or things of that sort, which we can
16 call common costs. So there would be some sort of recovery of those. But what I had taken
17 it as meaning was that that was all sort of bundled up overall, that there was a right or some
18 narrow set of right incremental costs in that respect.

19 Q There must be some assumption, then, that the common costs recovery from the entrant is
20 going to be different from and lower than the common costs recovery from the BT
21 incumbent?

22 A I don't think that's what's being -- I think there may be some misunderstanding about what
23 was being said. Our exchange - I was perhaps a bit slow in our exchange. I might not have
24 been transparent. It was probably my fault. But I think what was being said was that if you
25 thought - of course there might be a number of different ways of doing it - but whatever the
26 costs were from a pass of a notional passive to active business, the passive to active
27 business costs of the new entrant might be higher than those of BT, but because BT was
28 recovering in its active access product more common costs than the price of the passive
29 access, that meant that the final cost of the passive access seeker ended up being below that
30 of BT.

31 Q I think your assumption, then, is that it is a retail minus approach, or some sort of minus
32 approach rather than the costs plus approach to working out what the costs components
33 would be for the entrant?

1 A I think it's just some sort rolled up, slightly vague (at least slightly vague in my head) set of
2 the costs of a passive to active business.

3 Q If you had geographically de-averaged pricing, which I think you accepted might well fall
4 to happen, at least in part, does that mean that you necessarily end up with higher prices in a
5 given geographical region than another? Retail prices, sorry.

6 A I'm not sure that it does necessarily mean that for a number of reasons. First of all, clearly
7 the process of passive access itself - well, do you mean higher prices in some regions than -
8 sorry.

9 Q Retail prices.

10 A So the retail price in some regions may - it's not obvious that the retail price in any region
11 would go up. It could be that, for example, the process of competition through passive
12 access was itself sufficient to drive down prices by more than would be the consequence of
13 the de-averaging in any one region. So that's one kind of factor. Another point is I guess
14 that there may be scope for the retailers to absorb more geographical differentiation in their
15 overall decisions about pricing. So if it turns out that they found it efficient to charge the
16 same sort of retail price in different areas, even though the passive access price charged was
17 slightly different, that would change the structure of their costs recovery between the
18 passive and the active components. So it's not absolutely clear, but I do think that it's the
19 natural assumption that you would end up, if you had geographically de-averaged passive
20 access prices, with some geographic de-averaging on the active access to the extent that
21 geographic averaging is not a proxy or a subset of bandwidth differentiation. So all of this
22 is conditional upon the point that I've made a number of times, that it may well be that you
23 end up (because this isn't a point on which I have any particular knowledge) that the highest
24 bandwidth use also tends to occur in the areas of highest geographical costs recovery.

25 Q You mentioned Mr. Culham referring to cost benefit analysis. Was cost benefit analysis
26 something that you saw mentioned in terms in the BCMR statement?

27 A I don't recall that particular form of words. It's not impossible. Cost benefit analysis is
28 such a familiar term that it's possible that I would have read past it and just thought it was
29 one of those things that you always read in regulatory documents. If you want to point me
30 to it - I don't recall there being any area of the BCMR where it's set out in a systematic way
31 saying: these are the key sets of costs; these are the key sets of benefits. Oftentimes in
32 regulatory submissions they have a formal thing called the cost benefit analysis and might
33 have a table which gives you what they think are the costs and the benefits. I'm not aware
34 of anything which systematically rehearsed it in the BCMR.

1 Q Did you see anything in the statement that expressly was the benefit of competition being
2 weighed against the detriment of disruption to BT's pricing system which gave the common
3 costs recovery that --

4 A Only in a general way. Of course, at some general level Ofcom said we take account of
5 these considerations and we take account of those. So in a kind of vague sense of course
6 there was some offsetting of costs and benefits, but I didn't see them referred to in any
7 systematic way that would lead you to find it odd that there wasn't an attempt to quantify it.
8 That sort of way of framing things, where you're driven to seek to quantify, just didn't seem
9 to be the way it was thought about. Not that unnaturally, given that what you're talking
10 about is the consideration of the introduction of a remedy. It didn't seem odd to me that
11 you would have thought that the key considerations in the introduction of a competition
12 enhancing remedy wouldn't be those of either a static or a dynamic cost benefit analysis.
13 The key considerations, I would have thought, would have been of other types of more
14 general economic types.

15 Q Moving on to what you described as the need to have payments in the event of breach to
16 ensure that undetected cases were reflected in the welfare calculus as I see it, is that fair?

17 A Yes.

18 Q The fact that damages for a specific breach would not necessarily reflect the wider societal
19 loss?

20 A Yes, I've called them damages for breach. That form of words is perhaps a little bit
21 narrower than the kind of thing -- All I guess I'm saying is that there have to be enough
22 consequences for the person that breaches that they don't want to do it.

23 Q Could those consequences include such things as, for example, an aspect of regulatory
24 control in the event of a complaint?

25 A Absolutely, of course.

26 Q Termination of the contract full stop for non-compliance?

27 A Absolutely. Withdrawal of some sort of licence, greater scrutiny.

28 Q Finally, there was a reference, I think you were asked about data protection issues on behalf
29 of people who are seeking duct access. Do you know whether or not Openreach would be
30 precluded or not precluded from disclosing confidential material submitted to it in its
31 instructional capacity as a passive provider of access?

32 A I've no expertise on that question at all.

33 Q Thank you.

1 THE CHAIRMAN: I have just got one question for you, Dr. Lilico. I think I heard you say that
2 (I realise this was in the abstract) a regulator, faced with market power, should not just
3 restrict itself to managing that market power but should try to undermine it?

4 A Yes.

5 Q From your experience and observation of regulators, do you find that that is what they tend
6 to do?

7 A I think many regulators do seek to try to promote competition. You can think of things,
8 recent developments say with Ofwat's introduction of changes encouraging retail
9 competition there. Over time you would think of the introduction - you think of the
10 regulatory process in things like the energy sector, the power generation, auctions and so
11 on, the breakup of structure. Sometimes you begin with quite vertically integrated entities
12 at the time that you first privatise them, and it takes you a while to get to a regulatory
13 framework that looks more like what you want. But I think that if you look at the history of
14 regulated entities in the UK since privatisation you would find that typically it took the form
15 of shifting towards more changing the structure of the industry over time so that the
16 regulator could better facilitate competition.

17 Q The regulator's job is to regulate itself into extinction, or to remove the need for it to be
18 there?

19 A I think a regulator is a bit like a dentist.

20 Q Painful if you are a patient!

21 A Perhaps, yes. But I think that what you want from the regulator is, in the end, for you to
22 only have to have occasional checkups. What you want to do is to get rid of the process of
23 regular fillings. The regulator should not be filling in what you are brushing, or your
24 competition in this analogy should be able to do instead of the regulator.

25 Q You should not remove all the teeth either, presumably.

26 A Yes, indeed.

27 Q Any of my colleagues got a question?

28 MISS POTTER: I think just one question for clarification in terms of geographical variation. I
29 think we have probably been talking a little bit to date about the possibility that costs would
30 rise for customers and users in those areas where there was not the same demand and the
31 same degree of competition. But actually, I think I understand you as saying that if
32 anything you would envisage a situation in which you would perhaps expect to see a
33 premium for areas of greatest demand so that duct space, because it was more sought after,

1 where there were a lot of customers, there might be a higher charge. Is that right, or am I
2 wrong about that?

3 A No, I think that may well be. I think that would probably - I would have thought that was
4 the most natural thing to expect. If you had a market with multiple players where people
5 were selling duct access, then what you are talking about is selling a kind of space, and the
6 same kind of considerations that lead to space being more expensive in inner cities than in
7 rural areas would probably lead to space being more expensive in this respect as well.

8 Q Thank you.

9 THE CHAIRMAN: Thank you very much, Dr. Lilico. You are released as far as we are
10 concerned.

11 Witness withdrew

12 MR. BEAL: Sir, I think that means in terms of timing we have got a clear run tomorrow with Mr.
13 Culham and Dr. Maldoom. I have already indicated to my learned friend Mr. Beard that
14 given that Dr. Maldoom, I assume, will be sitting through my cross-examination of Mr.
15 Culham, I would try the Tribunal's patience and my sanity if I simply repeated the same
16 questions the second time round. So I may have to think of a form of words in which I put
17 my general case to Dr. Maldoom but allow him to turn round and say that he stands behind
18 Mr. Culham. I am simply flagging that up in terms of time.

19 What that does mean is that we will be done tomorrow in terms of the evidence and we then
20 have the timetable that we have set down for Thursday.

21 THE CHAIRMAN: Do you think you will take the whole of tomorrow?

22 MR. BEAL: I think I will take the majority of tomorrow. Probably I will finish at about 3
23 o'clock. Quite a lot depends on the length of the answers.

24 THE CHAIRMAN: You would rather end there than start your closing straight away?

25 MR. BEAL: Can I take a view on that, because obviously I have to think about my cross-
26 examination of two expert witnesses, or one witness of fact.

27 THE CHAIRMAN: You might be able to have two bites at it!

28 MR. BEAL: I think the others would like it first time round. Let us see. I suspect I will not do
29 that, because I think that would be difficult. Can I take a view on that. My preference
30 would be to have a little time to collect my thoughts, but it is possible that I can deal with
31 grounds 1 and 4.

32 MR. HOLMES: Sir, I have no desire to heap pressure on Mr. Beal because I appreciate that he
33 has a task ahead of him with two witnesses tomorrow. I would simply note that if there
34 were any way that certain points could be broken off and dealt with tomorrow, it might be

1 sensible in view of the large number of issues that need to be dealt with in closing. I do not
2 say more than that.

3 THE CHAIRMAN: I am conscious, first of all, that we have to give you your time to make your
4 case. On the other hand, the Thursday schedule is still quite a heavy one. If there are parts
5 that can be dealt with tomorrow if we are making progress on the evidence (without
6 curtailing it in any way) I think we would appreciate that too.

7 MR. BEAL: If I can use best endeavours to knock off grounds 1 and 4, and then use the time
8 allotted to me, minus that, for grounds 2 and 3.

9 THE CHAIRMAN: You can add ground 2 to that list and see how you go. It is my ground 2; I
10 hope that is your ground 2!

11 MR. BEAL: I refuse to budge on the grounds.

12 THE CHAIRMAN: In that case, we have finished for today. See you at 10.30 tomorrow.

13 (Adjourned until 10.30 a.m. on Wednesday 16th October 2013)
14