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IN THE COMPETITION
APPEAL TRIBUNAL

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

Victoria House,
Bloomsbury Place,
London WC1A 2EB

15th November 2013

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

BETWEEN:

BRITISH TELECOMMUNICATIONS PLC Appellant

- and -

OFFICE OF COMMUNICATIONS Respondent

AND BETWEEN:

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

- and -

OFFICE OF COMMUNICATIONS Respondent

AND BETWEEN:

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

- and -

OFFICE OF COMMUNICATIONS Respondent

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H E A R I N G D A Y E L E V E N

A P P E A R A N C E S

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

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

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

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

1 THE PRESIDENT: Yes, Mr. Pickford.

2 Mr. GEOFFREY RICHARD PLATT MYERS, Recalled

3 Cross-examined by Mr. PICKFORD

4 Q Mr. Myers, if you could please take out bundles BT8, DF2 and AD2, I am going to go all
5 three of those, but we will start with AD2 [tab 36]. It should have the table that your
6 counsel handed up yesterday?

7 A Yes.

8 Q Which shows that the SAC for the five key components of BES and WES together is £2.371
9 billion?

10 A Yes.

11 Q That is just the key components. Do you have any idea of how much the total SAC would
12 be for the Ethernet products?

13 A Sorry, I haven't looked at that. My understanding is that these key components cover the
14 substantial majority of the costs.

15 Q The equivalent SAC for a single Ethernet product will be obviously less than for a group of
16 products, but still in a similar order of magnitude, will it not, because although you can
17 deduct the LRICs and you can deduct some of the common costs, inevitably a vast bulk of
18 the common costs will remain?

19 A Yes, that's right. I think the characteristic you're pointing out is that there will be common
20 costs that are present in the stand-alone cost of two different Ethernet services, so there will
21 be substantial overlaps if you're counting them both, which is why the sum of the stand-
22 alone costs of services is much larger than the combinatorial stand-alone cost.

23 Q Exactly, and if we look at columns 1 and 3, we see the sum of those. They add up to
24 something greater than the combinatorial, but not so much. Similarly, columns 2 and 4,
25 again they add up to something greater than the combinatorial, but again the difference is far
26 less?

27 A Yes, that's right. I think the point is that the combinatorial stand-alone cost is much less
28 than the sum of the stand-alone costs for each of the five components.

29 Q If we could have a look, please, for the DSAC for a single Ethernet product, could you pick
30 up bundle BT8, and turn to tab 17. We have been to pp.40 and 41 a few times. It is the
31 RFS for the AISBO market. Do you have that?

32 A Yes.

33 Q Could you go to p.41, please, which is the BES products - do you have that?

34 A Yes, I have that.

1 Q If you look at the top line, just by way of example, we see volumes of 3,500 lines
2 approximately - do you see?

3 A For BES 100?

4 Q For BES 100, exactly.

5 A Yes.

6 Q We see an unaudited LRIC ceiling, which is the DSAC figure?

7 A The DSAC, yes.

8 Q Of approximately 2,000, very roughly?

9 A Yes, I see that.

10 Q So that gives a total DSAC for that service alone of around 7 million, very roughly, if you
11 multiply the two together.

12 A I see, right. The figure is not actually shown on here.

13 Q It is approximate, but if you multiply the 3,500 lines by 2,000, the DSAC figure is about
14 7 million, just an illustration.

15 Q That obviously compares to the SAC figure which is likely to be in the billions?

16 A Yes, there will be a very large gap between the DSAC and the pure stand -alone cost.

17 Q If we could go, please, to p.19 in this document, you should have a page entitled "Review of
18 Access Markets"?

19 A Yes.

20 Q We see here the AISBO market, all bandwidths, is towards the bottom of the first set of
21 figures - do you see that?

22 A Yes.

23 Q If you go four columns along, we see the total turnover of 439 million?

24 A Yes, I see that.

25 Q We see also here that there is a whole range of other products, all of which will tend to share
26 substantial common costs with AISBO - that is correct, is it not?

27 A Yes, I would imagine that these services and indeed other services will share common costs
28 with AISBO.

29 Q We would expect BT to be recovering its common costs, obviously not just from AISBO,
30 but across all of these markets?

31 A Absolutely, yes.

32 Q Given how large the SAC figure is for an individual service and how it compares to the
33 DSAC that we have seen, in the context of the practical application of a cost orientation
34 obligation, it would be meaningless to apply a SAC limit to an individual charge, would it

1 not? That would be silly?

2 A Well, it would certainly be silly unless there was a substantial set of combinatorial tests also
3 being conducted. To just look at a SAC test on its own would, I agree, provide clearly
4 insufficient limit on pricing flexibility.

5 Q You exhibited in your statement in these proceedings your statement in the PPC case - that
6 is in bundle DF2 that I also ask you to pick up. You can put away BT8 for the time being.
7 Can you go to para.29 of your statement, which is contained in tab 12 of DF2. Do you have
8 that?

9 A Yes.

10 Q This is a point that we touched on yesterday, but I want to be very clear about it for the
11 purposes of today. You explained here in para.29 that where Oftel is referring to ceilings
12 and also the SAC ceiling in the context of cost orientation, it is talking about DSAC. It is
13 not talking about SAC?

14 A It's usually talking about DSAC, I think there might be cases where it's actually referring to
15 SAC and combinatorial tests, and I think in the bundle that was given last night there
16 seemed to be some examples of that in there, but I don't think ----

17 Q We will come to that. We see in footnote 20 that you explain that Ofcom was still using the
18 term "ceiling" to refer to DSAC in the 2004 Leased Line Market Review, and you give an
19 example of table B.4, and you say that this table referred to BT's price for 2 Mbit/s trunk
20 services being above the SAC "ceiling". In the text accompanying the table Ofcom noted
21 that:

22 "…for trunk segments, the prices charged for all identified bandwidths is well
23 above the stand-alone cost ceiling as determined by BT" (paragraph B.108). The
24 SAC ceiling figure is that set out by BT in its Regulatory Financial Statements for
25 2002/03, i.e. the DSAC ceiling."

26 A Yes, I agree that those references to "ceiling" or "SAC ceiling" were references to DSAC.

27 Q You went yesterday with Mr. Thompson to paras.76 to 79 of your witness statement. I do
28 not need to take you to them again. The core point that you were making there was about
29 the importance of regulatory certainty, and your point was that Sky and TalkTalk's approach
30 was contrary to regulatory certainty?

31 A I wouldn't mind just looking at it.

32 Q You would agree that you make that point?

33 A It won't take long. I just would care to refresh my memory.

34 Q Of course.

1 A (After a pause) Yes, I agree.

2 Q You are very clear in your view that if you interpreted and applied condition HH3.1 as
3 imposing a FAC based test in order to prevent multiple recovery of common costs, that
4 would be inconsistent with what Ofcom was signalling to BT and the market when it
5 imposed condition HH3.1 in 2004?

6 A Well, I think the specific point was that it's, in my view, inconsistent with Ofcom's decision
7 in 2004 not to impose a price control.

8 Q Your case obviously is that the DSAC test is consistent with the signals that Ofcom were
9 giving?

10 A Yes, that's correct.

11 Q In addition to the 2004 statement, which I will be coming to, if you are concerned with what
12 was being signalled to BT about the application of a cost orientation obligation, you would
13 also want to consider what relevant statements had been made in the run-up to the
14 application of that condition, would you not - prior to the imposition of that condition?

15 A Potentially. It depends on whether they are superseded by comments or decisions made in
16 the 2004 Market Review, but I accept they could potentially be relevant.

17 Q A point that you discussed with Mr. Thompson yesterday was the point in time at which you
18 need to have information for the purposes of regulatory certainty, and he put it to you, and
19 you agreed, the proposition that the relevant moment is just prior to BT setting its charges.
20 That is the moment he said that you should judge what BT knows. Do you recall that?

21 A Yes, I recall. I think I said "contemporaneous". It amounts to the same thing, yes.

22 Q But can I put this to you, if by June 2004, when Ofcom imposed Condition HH3.1, Ofcom
23 had given BT and the market a very good understanding of how it was going to apply a cost
24 orientation obligation, it would tend to undermine regulatory certainty if you then gave
25 contradictory signals after 2004, even if they happened to be prior to the imposition by BT
26 of its prices.

27 A I am not sure I quite follow that.

28 Q I am sorry. It is a bit of a long question. I will try and break it down. Let us suppose that
29 Ofcom gave, both in the 2004 statement and the statements it made prior to it, clear
30 guidance to BT about how it was going to apply the cost orientation obligation. That is an
31 assumption, okay?

32 A Right.

33 Q If after it had imposed the obligation it then started giving different and contradictory
34 signals about how it interpreted cost orientation, that would be likely to undermine

1 regulatory certainty, would it not, because you would have a tension between what BT
2 understood at the time of the imposition of the price control and what it was then being told
3 thereafter when it was actually trying to comply with the price control?

4 A So I think I see that possibility. I find it slightly difficult to comment without seeing
5 something more specific.

6 THE PRESIDENT: You are just saying if Ofcom gave contradictory guidance or signals to BT or
7 the market would that undermine regulatory certainty. It is a general proposition and I
8 expect anyone would agree with it. That seemed to be really what your question was.

9 MR. PICKFORD: It is a general proposition and we are going to then look at specifics.

10 THE PRESIDENT: It is a hypothesis. Telling people contradictory things undermines certainty.

11 MR. PICKFORD: Indeed. It was not supposed to be a trick question or a difficult question. It
12 was just to establish the general principle before we looked at the specifics.

13 THE PRESIDENT: I think that is probably common ground.

14 MR. PICKFORD: You are aware of the Phase 1 and Phase 2 directions involving PPC, are you
15 not, because you refer to them in your statement in the *PPC* case?

16 A Yes, I am aware. Yes, I do not recall all the details of exactly what each related to but I
17 recall there being Phase 1 and Phase 2 directions.

18 Q Were you involved in any of those directions?

19 A I think I would need to refresh my memory on exactly what those directions covered. In
20 general during this period of time I was at Oftel and I was working on some leased line
21 issues, so I think I was involved in some of those documents but I cannot recall whether I
22 was working on all of them.

23 Q I will help refresh your memory as to the sequence and then we will go to the specific
24 documents. There were three documents. There are three directions. There was a Phase 1
25 direction and a Phase 2 direction. In the initial direction that imposed an obligation on BT
26 to supply PPCs to various CPs and an obligation to agree terms. Then in Phase 1 there was
27 a resolution of a dispute about some of those terms, and then in Phase 2 Oftel then finally
28 set cost orientated prices. Do you recall any of that?

29 A That does ring a bell, and I do not have a perfect recollection, but I suspect I was involved
30 in the Phase 2 direction. I am not sure I was involved in the earlier two directions.

31 Q If we could turn, please, to the initial direction, which is at the front of the clip of documents
32 I handed up yesterday, so that should be found now hopefully -- It does not matter, if you
33 have got it separately. That is absolutely fine. Everyone else can hopefully find it at Tab 39
34 of AD2. If you could turn please to Chapter 1, which is on external p.13. Do you have

1 that?

2 A I have that, yes.

3 Q So we see here, in terms of background, at 1.1 the Director-General of Telecommunications
4 has issued a direction. It then goes on to explain, halfway down, the direction requires BT
5 to enter into agreements with various operators and that is to provide partial private circuits
6 on terms and conditions to be negotiated between BT and each of the operators within the
7 framework laid down by the ICD. Do you see that?

8 A Yes.

9 Q Then just some further background again for orientation. We see at 1.4:

10 "Energis have been attempting to negotiate with BT for provision of PPCs. Those
11 negotiations have been unsuccessful".

12 Then at 1.5:

13 "OfTel have been approached by other operators who also wanted whatever deal
14 Energis was going to get".

15 Can you see that?

16 A Yes.

17 Q Then we could turn, please, to external p.19, that deals with the terms and conditions for
18 supply. We see that the direction states:

19 "All terms and conditions for supply of PPCs are to be negotiated between BT and
20 each of the operators. However, those negotiations must reflect the obligations with
21 which BT is obliged to comply in respect of interconnection provided to other
22 Schedule 2 public operators".

23 It then goes on to say:

24 "Interconnection is provided by BT under Condition 45.1 and as such are Standard
25 Services" ----

26 MR. READ: I am sorry to interrupt my learned friend, but I am trying actually to find which
27 document we are actually referring to at the moment because he is talking about the Phase 1
28 direction or is he actually talking about the direction under 54.2 of the ----

29 MR. PICKFORD: I am talking about the first direction and I am coming on to p.16, external
30 p.20, of the tab of documents.

31 THE PRESIDENT: This is the document that starts at the beginning of this tab, the one that starts
32 at p.3 at the beginning of Tab 39. Is that right, Mr. Pickford?

33 MR. PICKFORD: That is correct.

34 MR. READ: The problem is that I thought he was saying it was the Phase 1 direction which, in

1 fact, I think occurs as little later.

2 MR. PICKFORD: That occurs later but I am not taking ----

3 THE PRESIDENT: We are not there yet.

4 MR. PICKFORD: We see that the CP is required to ensure that its charges are cost orientated and
5 that is by Condition 69.1 of BT's licence. We see that in para.1.32. Yes?

6 A Yes.

7 Q The critical paragraph is para.1.33, and you obviously saw this yesterday and anticipated no
8 doubt where I was going to go when you read the documents:

9 "Of tel's view is that the appropriate interpretation of the requirement for prices to be
10 cost orientated cannot be considered in isolation from the extent of competition for the
11 service in question. For example, if the provision of the service in question was
12 effectively competitive or moving towards a competitive market structure then Of tel
13 would interpret the requirements for cost orientation as meaning any price between
14 the long run incremental cost (LRIC floor) and stand-alone cost (SAC ceiling), subject
15 to any relevant combinatorial and non-discrimination tests also being satisfied."

16 So just pausing there, when it refers to the stand-alone SAC ceiling, it must be referring to
17 the DSAC ceiling, not a SAC ceiling?

18 A Yes, I agree in that case. I think that must mean DSAC.

19 Q That must mean DSAC, yes. Then if we continue ----

20 A I am sorry, I apologise. I do not think what I just said is actually correct. The point is,
21 looking at that sentence again, it talks about between DLRIC floor and stand-alone cost
22 ceiling "subject to any relevant combinatorial and non-discrimination tests also being
23 satisfied". So I do not think therefore it is actually clear that that necessarily is referring to
24 DSAC because if you use DSAC you do not need to use combinatorial tests. DSAC, as has
25 been established I think, is a pragmatic alternative to combinatorial tests. Whereas if you did
26 use the true SAC ceiling, which, as we discussed before, is likely to be extremely high at the
27 level of an individual service, that would only make sense if you are also doing
28 combinatorial tests. So actually the reference here to "subject to any relevant combinatorial
29 tests" makes me think that this might be referring to the true SAC rather than to DSAC.

30 Q But DSAC does not actually remove the need for combinatorial tests. It is just your
31 approach because combinatorial tests are difficult. You decide, you say, to use DSAC
32 instead. But this does not remove the need, if you are actually going to demonstrate cost
33 orientation, to carry out combinatorial tests, does it?

34 A But they are alternatives. The theoretically derived possibility that arises from the theory of

1 contestable markets, would be looking at every service price between that service
2 incremental cost and the service stand-alone cost, but also applying all combinatorial tests.
3 So any combination of that service with other services that also share the common costs.
4 And in the case of BT and the common cost we are talking about, that would be literally
5 hundreds of services and thousands upon thousands, and possibly even millions, of
6 combinatorial tests if you were going to do the full test. You might be able to refine that a
7 bit to the more important ones but, in any case, it is a very large exercise. So that is one
8 possibility. The alternative, and essentially the reason why Oftel originally and Ofcom has
9 adopted DSAC is that avoids the need to do the combinatorial tests. It establishes the test at
10 the level of individual services which is constructed in a way that it means if that test is
11 satisfied it is reasonable to expect that to satisfy cost orientation without the need to conduct
12 combinatorial tests. So I think they are alternatives and it is on that basis that I say the
13 DSAC is constructed as a test of individual services to avoid the need to conduct
14 combinatorial tests.

15 Q If combinatorial tests were not viable it must be referring to DSAC?

16 A So if it is encompassing both possibilities, which it could be, it might be saying that you
17 would either need to use the individual service SAC but then you would need to do relevant
18 combinatorial tests, or, as an alternative to that, it might be implying that you could use
19 DLRIC and DSAC instead. It may be covering both possibilities as alternatives.

20 Q Then it goes on to say ----

21 THE PRESIDENT: When you say "both possibilities as alternatives" ----

22 A That is clearly not explicit. That I would say would be implicit given the history of the
23 logic underlying essentially that I just briefly outlined, of where DSAC has come from as an
24 alternative to SAC plus combinatorial tests.

25 Q Yes, because it says here "stand-alone cost (SAC ceiling), subject to any relevant
26 combinatorial and non-discrimination tests also being satisfied".

27 A Yes, so, as I say, that is why I think I corrected myself to say that actually I think, on the
28 face of those words, that seems to be referring to the individual service stand-alone costs,
29 not the DSAC and combinatorial tests. But I think Mr. Pickford just put to me that, given
30 the history of all of this, if that is all recognised as being impractical, which in various
31 documents that has been discussed, that it might be recognising that there is an alternative or
32 you might be able to read into this that it is encompassing the alternative to what is set up
33 here as SAC and combinatorial tests.

34 Q The alternative is an alternative, not an alternative meaning of stand-alone cost SAC ceiling

1 but an alternative to the entirety of that approach. Is that right?

2 A I do not think you can split them apart in that way. If you are taking the individual service
3 stand-alone cost ceiling then you have to do the combinatorial tests in combination with
4 that. Just doing the individual service stand-alone cost, as I discussed it just earlier with Mr.
5 Pickford, would provide almost no constraint on pricing. So the combinatorial tests are a
6 necessary adjunct to individual service stand-alone costs. So they essentially come as a pair
7 and DSACs is an alternative to that pair.

8 Q To the pair, that is the point.

9 MR. PICKFORD: That is obviously if you interpret this as SAC. Given the context, which is a
10 practical application of the cost orientation obligation, it would be pretty strange, would it
11 not, for Oftel to be saying that any price between LRIC floor and the stand-alone costs
12 ceiling which we have seen ... could be billions of pounds was sufficient subject to tests
13 that they know you could not actually practically implement? That would be an odd thing
14 for Oftel to be saying?

15 A But that is not what they are saying, because this talks about relevant combinatorial tests as
16 well. A natural reading of these words is it's referring to individual service, stand-alone
17 costs plus combinatorial tests. I wouldn't deny that given the history of the development of
18 all of that and the development of DSAC that you might read DSAC as an alternative to that
19 pair, but that's not what these words say to me explicitly.

20 Q We will move on to the next part of the paragraph. It goes on:

21 "However, if by contrast the relevant economic market was not effectively
22 competitive then the Director will be inclined to interpret the cost orientation
23 requirement to mean that prices should be set on a LRIC basis with some
24 allowance for common cost recovery."

25 So it is drawing a distinction there, is it not, between two different situations. Firstly, where
26 the market is either competitive or moving towards competition; secondly, where the market
27 is not in fact competitive and the different approaches it would take in either case?

28 A That's right, and I think essentially the last sentence is referring to a kind of tight control,
29 costs plus rate of return type regulation on prices in those relevant market conditions.

30 Q The Ethernet market in 2004 fed into that second category, did it not, because it was not
31 moving towards a competitive market structure? The wholesale Ethernet market, sorry.

32 A So there was SMP, which means it wasn't effectively competitive, but in terms of moving
33 towards a competitive market structure, I think that really takes us to the question of how
34 much prospect there was for entry, what Ofcom's view was of the importance of that, etc.

1 Actually, I'm not sure it fits neatly into either of these kind of categories.

2 Q We will come on in a moment to the 2004 statement, but actually it was Ofcom's view in
3 2004 that the Ethernet was not prospectively competitive; there was no sign to Ofcom of
4 there being substantial entry likely to take place.

5 A I think we have to be slightly careful how we're defining prospectively competitive because
6 I have become aware it's been defined slightly differently at slightly different times. But I
7 certainly agree that the 2004 Market Review concluded that BT had SMP in this wholesale
8 Ethernet market, and that Ofcom took the view that that SMP was likely to persist over I
9 think it was the next two to three years. Perhaps when we come to the statement we could
10 check that. Obviously, the Market Review was a forward looking assessment of SMP, not
11 just a current assessment. There was a forward looking conclusion. But it was an immature
12 market and in an immature market, even if there are significant barriers to entry, is it quite
13 important to think about whether entry might occur because clearly the conditions of
14 competition are just less established in an immature market. That's quite a difficult set of
15 judgements that need to be made about whether there's any prospect of entry, how much
16 prospect of entry, how important or useful that might be in terms of longer-term
17 developments in the market. All of those things require quite careful judgements in the
18 context of the market really looking at the specific circumstances.

19 Q Could we move on, please, to para.1.36. We see that:

20 "Ofcom expects BT to negotiate prices with the operators within this framework. If
21 prices cannot be agreed and Ofcom were required to resolve a dispute, it would, as a
22 general rule, other things being equal, expect the appropriate price to be closer to
23 the LRIC floor for those services which are least competitive. This would mirror
24 the approach taken, for example in setting network charge controls."

25 So what Ofcom is telling BT is firstly to expect disputes to be determined by it with prices
26 close to the LRIC floor where there is not sufficient competition?

27 A So yes, what I think this is saying is that the cost orientation obligation is essentially
28 covering almost, if you like, two roles. One is kind of the pricing flexibility role and the
29 other one is effectively performing a function of a price control in the form of a cost plus
30 control. I think what this is saying is in the circumstances where Ofcom would in principle
31 consider a price control would be warranted, given the market circumstances, then that
32 would be covered by cost orientation and that would imply the restrictive interpretation of
33 cost orientation, a similar cost standard as Ofcom used and Ofcom continues to use when
34 setting price controls.

1 Q Could we move then please to the Phase 1 direction. You exhibited that to your witness
2 statement in the PPC case, but the exhibits have not transposed so I attach it in a clip.
3 Would you go, please, to p.31.

4 A Yes, I have it.

5 Q You have that. We see here in the recitals, if you turn over to p.34 para.12:
6 "In August 2001 the director received several requests to determine a dispute. It is
7 clear to the director and self-evident from the fact that he has received requests for
8 a Determination that despite the signing of the PPC contract and the negotiations
9 which took place in the context of the March 2009 Direction, the operators remain
10 in dispute with BT over a number of issues."
11 It then sets out the licence obligation in relation to cost orientation. Then we see at paras.16
12 through to 18 that the director is sticking with his view about the two contrasting
13 approaches that he would take to cost orientation, depending on whether the market was
14 prospectively competitive or not, is he not?

15 A Yes.

16 Q Like any well-advised public body, he obviously does not fetter his discretion, but he does
17 say what he would be, in general, minded to do, subject to the facts of a particular case.

18 A That's right.

19 Q Could we then go please to Phase 2 to see what he finally did. We find that in the same
20 bundle, but it is back at tab 15. This was already in the documents.

21 A Sorry, I don't have that bundle open.

22 Q We are in bundle AD2 tab 15, please. Do you have there a document entitled "Partial
23 private circuits Phase 2"?

24 A Yes.

25 Q The date is 23rd December 2002. If we go, please, to p.6 (numbers at the top), this is part of
26 the Direction and you see at para.4 that the prices are being set retrospectively for a period
27 between 1st August 2001 and 31st July 2002?

28 A Yes, I see that.

29 Q Then also in para.5 they are also being set, partially retrospectively, going back to August
30 2002 but there is no outer limit on that, so that is obviously also the prices being set on a
31 forward looking basis?

32 A Yes.

33 Q Then if we could go, please, to p.43 we see at S10 that the Director had obviously taken the
34 view that:

1 "The charges notified by BT in August 2001 were not cost-oriented, contrary to the
2 requirements of the March 2001 Direction."

3 That is what we saw at the outset.

4 A Yes.

5 Q So what the Director does is to go on to make them cost oriented. If you go on to p.81 we
6 see in para.3.1 that the Director sets out his views on the cost orientation of BT's PPC
7 charges. You see that, just for context?

8 A Yes, sorry, I was just reading para.3.1. Yes, I see that.

9 Q Then if you turn over the page, we see what he has to say about it. Go to para.3.9. Do you
10 have that?

11 A Yes.

12 Q You see:

13 "The Director has stated that long run incremental costs (LRIC) plus an equal
14 proportionate mark up (EPMU) is the appropriate method to determine cost
15 orientated prices for PPCs. This allows BT to recover, from network charges, the
16 LRIC of providing PPC services and, in addition, an EPMU to allow a reasonable
17 contribution to the recovery of the common costs of providing access and
18 conveyance. Setting prices on this basis should result in a set of prices not
19 inconsistent with those that would be expected in a competitive market."

20 So the Director there is signalling to BT, certainly in the context of PPCs, the appropriate
21 method for deriving cost oriented prices.

22 A Yes.

23 Q If one turns over the page to para.3.22, if you could just read para.3.22 to yourself, please.
24 (Pause to read)

25 A Yes.

26 Q The Director is saying that CCA FAC in aggregate over all the services is a reasonable
27 proxy for the LRIC standard, the EPMU standard, but he is using the cost orientation. You
28 see that?

29 A Yes.

30 Q And he relies on similarities between LLU and PPC for that conclusion?

31 A Well, yes.

32 Q Similarities between PPCs and LLUs?

33 A Yes.

34 Q Then we see ultimately at 3.29 that:

1 "The Director reiterates his view that BT's PPC cost model at this time provides
2 the best information available to him on which to set PPC prices."
3 So that is what he then ultimately did?
4 A Yes.
5 Q Could you go to para.3.78 p.95. Do you have that?
6 A I have that, yes.
7 Q About two-thirds of the way down we see a subtitle "Pricing of enhanced care PPC
8 services", do you see that?
9 A Yes.
10 Q There is a discussion there of what BT was saying to Ofcom in the context of those
11 enhanced care PPC services. Could you read para.3.78, please. (Pause to read)
12 A Yes.
13 Q so we see here that as far as Ofcom was concerned, it believed that BT understood cost
14 orientation in this context to mean CCA FAC or LRIC plus EPMU.
15 A Yes, I see that in this context.
16 Q It says LRIC plus mark-up, but obviously any mark-ups that led to multiple recovery of
17 common costs would be inconsistent with the idea of also equating cost orientation with a
18 fully allocated cost measure, would it not?
19 A So yes, I think LRIC plus mark-ups would probably mean LRIC plus a proportionate mark-
20 up. That's probably what's implied, given its sort of equating it with CCA FAC. You took
21 me earlier to the point where those two were held to be sufficiently similar, or CCA FAC
22 was held to be a reasonable proxy for LRIC plus equal proportionate mark-up.
23 Q And if you go, please, to para.3.127 on p.103 and read down to para.3.129. The three
24 directions that we have just seen are highly pertinent, are they not, in terms of the signals
25 that they were giving to BT about how Ofcom thought about the application of cost
26 orientation obligations at around this time?
27 A At that time, yes.
28 Q If we could then go on, please, to the Final Direction on that, which we will find back in the
29 tab that we were in previously, so if you could go back to your set of documents, I think you
30 will find it at p.39?
31 A Yes, I have that.
32 Q Were you aware of the LLU Backhaul Direction in 2002?
33 A At the time I'm sure I was. It's quite a long time ago, I don't have a very strong recollection.
34 Q When you wrote your witness statement in these proceedings you did not have it ----

1 A I didn't have it at the front of my mind, no.

2 Q BES services are a form of LLU backhaul, are they not?

3 A Yes.

4 Q And WES and BES are wholesale products which effectively replaced in many ways the
5 earlier retail product LES - that is correct, is it not?

6 A Yes, that's my understanding.

7 Q Could we turn to the beginning of this document, and turn to p.41 and look at S1, you will
8 see:

9 "The statement of directions sets out a requirement on BT to provide cost oriented
10 backhaul services ..."

11 Then we see at S2:

12 "As part of the consultation Oftel identified markets for backhaul links to provide
13 capacity from a local exchange to BT's trunk network, and backhaul trunk which
14 provides capacity across BT's trunk network. Backhaul links form two separate
15 markets; links provided by leased lines and those provided by local area network
16 extension services, LES."

17 So we see here that the backhaul direction concerns backhaul provided by leased lines and
18 LES backhaul, and therefore concerns the services which effectively became BES and
19 WES?

20 A Yes.

21 Q You obviously had an opportunity to look at this document yesterday. Could we turn,
22 please, to para.2.14, do you see there that the director is saying the same thing about how he
23 would interpret cost orientation obligations in this context as he said in relation to PPC?

24 A Yes, I see that.

25 Q Again, this is a highly pertinent document, is it not, in terms of the signals that the director
26 is giving to BT and the market about how it would interpret a cost orientation obligation for
27 products which ultimately became BES and WES?

28 A Yes. At that time, yes.

29 Q Could we turn, please, to p.51 of the clip. You should have there the Financial Reporting
30 Obligations in SMP Markets?

31 A Yes.

32 Q You were presumably aware that Ofcom consulted on the imposition of the Financial
33 Reporting Obligation in SMP Markets in 2003?

34 A Yes.

1 Q Could you turn, please, to para.3.47, which you will find on external p.54 - do you have
2 that?

3 A Yes.

4 Q This is just the beginning of the section, again for orientation, and we see here that there is a
5 discussion about LRIC and SAC. That is the only point that I am asking you to see there,
6 just so that you can see the context.

7 A Yes, I see that. I'm just reading it carefully just to see if it refers to individual service, LRIC
8 and SAC, or DLRIC and DSAC.

9 Q I think I can assist you there. It does not elucidate that point. I was not going to stop here.

10 A I don't know if this matters, but perhaps we will come back to it. It looks to me like it's
11 more about the individual service, LRIC.

12 THE PRESIDENT: Would you like to just read it for a moment?

13 A Sure.

14 MR. PICKFORD: (After a pause) Have you read it, Mr. Myers?

15 A I have read that paragraph, yes.

16 Q Could we then go on, please, to para.3.52. There is a discussion here about combinatorial
17 tests as well?

18 A Yes.

19 Q It says:

20 "The combinatorial tests assess whether the dominant provider is failing to recover
21 its incremental costs for any combination of services. There was a corresponding
22 set of combinatorial tests in relation to the SAC, which assesses whether there is
23 any multiple recovery of common costs and accordingly whether charges are
24 excessive on that basis."

25 A So this discussion is couched in terms of the individual service, LRIC and SAC, and the
26 combinatorial tests?

27 Q Yes, and what it is saying here in 3.52, *inter alia*, is that multiple recovery of common costs
28 constitutes excessive charging?

29 A Yes.

30 Q That, in a nutshell, is Sky and TalkTalk's case, is it not, in these proceedings?

31 A As I understand it, although this is referring of course to individual service, LRIC and SAC
32 and combinatorial tests, it's not directly referring to DSAC.

33 Q No, but that is not the point I am making. My point is simply that multiple recovery of
34 common costs are being said here to constitute excessive charging?

1 A Yes, it says that here, I think. I agree it says that here. Whether that's sufficient to find
2 excessive prices may depend on what the relevant legal framework is and the relevant tests,
3 and economically speaking I think you might need more than just simple multiple recovery
4 of costs, although that clearly could point towards excessive prices, but you would need to
5 look at the other circumstances that were relevant to the case.

6 Q If we could turn, please, to p.59 of the clip, we have here BT's response to an early leased
7 lines consultation preceding the 2004 statement - do you see that?

8 A Yes.

9 Q If you could go, please, to the next page where you extracted question 9, that BT was
10 responding on. You will see about half way down that paragraph BT says this:
11 "However, a cost oriented regulatory approach necessarily carries an extra burden
12 of administrative management and system costs for BT and Oftel alike. Hence we
13 believe a move from the existing price cap regime to a cost orientation approach to
14 regulation in this type of environment to be unnecessarily heavy handed and
15 disproportionate."
16 Do you see that?

17 A Yes, I see that.

18 Q So what we see here is BT is resisting a proposed change from a price control to a cost
19 orientation obligation?

20 A I think I'd need to see or understand the specific context. This sounds like this is the
21 interpretation of cost orientation effectively means LRIC plus or FAC, because a price
22 control is, in principle, appropriate. So it's one specific interpretation of cost orientation that
23 seems to be in play here, though you might need to look at the underlying issue in the
24 documents to explore that further.

25 Q Could we move on, please, to the next document in the clip, which should be found at p.63.
26 We see this is "Principles of Implementation and Best Practice regarding F/L" - that is
27 forward looking - "LRIC Cost Modelling". In 2000 Oftel was a contributing Member of the
28 Independent Regulators Group ('IRG'), was it not?

29 A Yes.

30 Q You are aware, obviously having looked at it now but I presume before, that they produced
31 papers on best practice for national regulatory authorities?

32 A Yes.

33 Q And this was the paper that was produced on forward looking LRIC costs modelling?

34 A Yes, I see that.

1 Q Had you read this recently before I gave it to you yesterday afternoon?

2 A No, not recently.

3 Q Could you go, please, to p.67. We see about a third of the way down a paragraph that
4 begins:

5 "An initial *prima facie* test that a FL LRIC based price is cost oriented is that it lies
6 between the incremental LRIC floor and stand-alone ceiling ('SAC') costs. A price
7 below the LRIC floor would mean that not even all incremental costs would be
8 recovered (with no contribution to common costs); a price above SAC would mean
9 that an amount in excess of the LRIC plus all relevant common costs would be
10 recovered."

11 So far, so good, I think you are familiar with those principles?

12 A Yes, and this is referring to individual service LRIC.

13 Q Yes, and then in the following paragraph:

14 "In the situation in which the price of more than one product, service, component
15 or element is based on forward looking LRIC, including a mark-up for common
16 costs, this first test alone is not sufficient to demonstrate cost orientation. For
17 example, if all prices were set at SAC, no individual service would be deemed to
18 be priced excessively under the first test, but taken together the services would be
19 priced excessively since revenues are more than sufficient to recover all
20 incremental and common costs."

21 So what we see here is the IRG are saying that the type of tests that could apply to a single
22 product breaks down when you apply it to multiple products, and can lead to excessive
23 pricing?

24 A Well, I see it's couched in those terms, but I think the same argument would apply if you
25 were looking at the price of an individual service. You'd still find the individual service
26 stand-alone costs for the reasons we discussed earlier wouldn't be sufficient because that
27 would recover, if it was priced up to that level, the entirety of the common costs. All other
28 service prices would have to be set at incremental costs in order to avoid any over-recovery
29 of the common costs. So even if one was considering an individual service, the
30 combinatorial test would still be relevant. I see this is couched in terms of more than one
31 product, but I think the same argument applies, even if you're considering a single product.

32 Q If we look at the second paragraph that I took you to, it is clear, is it not, here that excessive
33 prices are being equated with prices that generate revenues that are more than sufficient to
34 recover incremental and common costs - do you see that?

1 A Yes, I see that.

2 Q DSAC gives rise to precisely that problem, does it not? If it is applied to multiple products,
3 it generates revenues that are more than sufficient to cover incremental and common costs?

4 A Well, that depends. I think it depends on the extent of the services across which it applies,
5 and what is happening on the other services that share those common costs. I don't think
6 there's a straightforward answer. If all services were priced up to DSAC, indeed there
7 would be over-recovery of common costs, but that's never the situation.

8 Q Just for completeness, if we turn to p.71 in the clip we see the short note that was produced
9 at the request of the Competition Commission by Oftel. We see that in para.1?

10 A Yes, I'm familiar with this note. I was involved in the preparation of this note. It's in the
11 context of mobile termination, I believe.

12 Q In para.4 it refers approvingly to the document was just looked at, as being written to assist
13 national regulators by advising on best practice?

14 A Yes.

15 Q If we could turn, please, to the 2004 LLMR statement.

16 A Can I put these papers away?

17 Q You can put that clip away, yes. Thank you. Pick up the statement which is probably best
18 done actually in BT3 because, although we have extracts in Core Bundle E we do not have
19 everything. When Ofcom takes a decision such as the imposition of a suite of SMP
20 conditions such as we see in the 2004 LLMR statement, the ultimate decision is taken by the
21 Ofcom board or, in some cases, under delegated authority. That is right, is it not?

22 A That is right.

23 Q The decision to impose the 2004 LLMR was taken, you may well have seen from the clip of
24 documents, at a board meeting on 15th June 2004.

25 A Yes.

26 Q The person with ultimate responsibility for it was the then partner in Competition
27 Investigations Sean Williams.

28 A That is correct.

29 Q And the director in charge was Jim Niblett.

30 A Yes, that sounds right.

31 Q Is it correct that the lead economist was Colin Garland?

32 A I was the Economic Director of this project. I am sorry, I cannot recall. Colin Garland was
33 involved, I think, in some of the price control issues. There were other economists involved
34 in the SMP analysis, for example.

1 Q You are not now, and were not in 2004, a board member or an executive committee
2 member, were you?

3 A No.

4 Q Did you attend the 15th June board meeting, do you recall?

5 A I do not recall, no. I do not recall.

6 Q You said that you were the Economic Director at the time in relation to this statement?

7 A Yes.

8 Q Did you have overall responsibility for the economic content in the statement?

9 A Yes.

10 Q We have seen, and it has been pointed out, that in your witness statement in these
11 proceedings, when you talk about the underlying thinking in the statement in a number of
12 cases you use words like "might", "this might have reflected something in the 2004
13 Statement". Would you like to go to those paragraphs or do you recall that general use of
14 language?

15 A Perhaps it depends on your question. I am aware I used that word, but it depends on your
16 question.

17 Q Given the conditional language you used, you were not purporting to explain subjectively
18 what Ofcom, as a corporate entity, actually thought in imposing the 2004 Statement, were
19 you?

20 A No, I based my interpretation on the words in the statement. As I have just said, I was
21 involved in this Market Review. In fact, I do not have a very clear recollection of the
22 further thinking on the issue of the Ethernet price control, the WES/BES price control.
23 Clearly I was aware of Ofcom's general thinking about such issues at the time, but my
24 analysis is based on the words in the statement and the reason in some cases I used the word
25 "might" is because clearly there is one paragraph setting out the decision and the reasons for
26 not imposing a price control, and certain things are not explicit in the language of that
27 statement such as it does not talk about allocative, productive, dynamic efficiency; it does
28 not talk about trade-offs explicitly, for example. So I was being very cautious in using the
29 word "might". I may be have been slightly over-cautious because I think my interpretation,
30 I believe, is the reasonable interpretation of those words. It also seems to me clearly
31 superior to some of the alternative interpretations that have been put forward.

32 Q If you could go, please, to p.20 of BT3, which I asked you to take out. "Summary of
33 Market Definition". Do you have that?

34 A Yes.

1 Q We see at 2.3:
2 "In formulating its approach to market definition, Ofcom has paid the utmost regard to
3 the Commission's recommendation".
4 Then at 2.6 it sets out paragraph 3.1:
5 "*Because market analysis is forward-looking, markets are defined prospectively*
6 *taking account of the expected or foreseeable technological or economic*
7 *developments over a reasonable horizon linked to the timing of the next market*
8 *review.'* Again, this is the approach followed by Ofcom. The market analysis has
9 been carried out on a forward looking basis, and where it was thought possible that
10 market conditions may change significantly between the time of this review and the
11 next time the next leased line market review is conducted (in approximately two years
12 from now), these changes are identified and discussed".
13 You obviously would agree that that is what Ofcom did?
14 A I am sorry, I would agree that -- What was your question?
15 Q You would agree that this is Ofcom saying the approach it is planning to take?
16 A Yes, Ofcom's market analysis in terms of market definition and SMP was a forward-looking
17 analysis.
18 Q Yes. If we could look, please, at the market power analysis, which is on p.393. It actually
19 starts on 388 but the part that I would like to look at, please, is on 393 under the sub-title:
20 "Control of infrastructure not easily duplicated". Do you have that?
21 A Yes.
22 Q We see from para.B418 that one of the points that Ofcom was making is that AISBO
23 circuits are not easily duplicable in the sense that significant amounts of time and money are
24 required in order to roll them out. If you could just look at the rest of that paragraph,
25 please? (After a pause):
26 A Yes.
27 Q Not a difficult question. I am quite sure you do not disagree with anything that is set out
28 here in that statement?
29 A No.
30 Q We then see a further discussion of similar issues in 419 and 420, but if I could take you,
31 please, to 421, we see in the middle of that that BT's advantage is very significant due to the
32 ubiquity of its network. Can you see that?
33 A I am sorry, that is the bit in brackets?
34 Q The bit in brackets, yes.

1 A "BT's advantage being very significant due to the ubiquity of its network". Yes, I see that.
2 Q That is in the context of talking about the duct and fibre costs in that sentence.
3 A Yes.
4 Q Then we see, over the page, a discussion of economies of scale. Can you see that at B422?
5 A Yes.
6 Q And then a discussion of economies of scope in the following paragraph. If you could read,
7 please, both of those paragraphs, B423 and B424? (After a pause):
8 A Yes.
9 Q We see here a familiar theme because we have this at the beginning, that a very big
10 advantage that BT has is that because many of the costs, for instance duct, are common it
11 can use those investments to provide a large number of services, and that gives it a major
12 advantage over its competitors.
13 A Yes, that is right.
14 Q Then we see a discussion, you do not need to read the detail, of vertical integration, another
15 consideration, at the bottom of that page.
16 A Yes, I see that heading.
17 Q Then distribution of sales network, that is another consideration that is taken into account.
18 A Yes.
19 Q Access to capital market, which is something else that is taken into account, and then if you
20 turn over to "Market entry related criteria", we find those on p.396.
21 A Yes.
22 Q We see:
23 "Barriers to entry are a strong feature of the AISBO market".
24 That was Ofcom's view at the time?
25 A Yes.
26 Q It says at the bottom:
27 "... it appears to Ofcom that in many cases these sunk costs represent a substantial
28 barrier to entry".
29 It then goes on to deal with the absence of potential competition in B435. Do you see that?
30 A Yes.
31 Q It explains what is meant by "potential competition", and then takes the view:
32 "The prospect of widespread entry by new firms appears to Ofcom to be limited. This
33 is due to:
34 Entry barriers

1 The current financial situation affecting many other communications providers; and
2 The fact that Ofcom is not aware of any widespread entry by new players having
3 occurred in the last two years".

4 Do you see that?

5 A Yes.

6 Q And then we have a discussion of barriers to switching.

7 "In Ofcom's view this market is characterised by barriers to switching. These include
8 various costs associated with switching, including those of simultaneously running a
9 BT AISBO circuit together with a self-provided one".

10 Do you see that?

11 A Yes.

12 Q Then finally, after various other factors that it also considers, we see the conclusions at
13 B441:

14 "...BT has significant market power in the market for AISBO. Ofcom has reached this
15 view based on its analysis of, primarily:

16 BT's high market share;

17 The advantages enjoyed by BT due to the ubiquity of its infrastructure and the
18 existence of barriers to entry, notably those provided by sunk costs;

19 The greater economies of scale and scope enjoyed by BT; and

20 The advantage that BT enjoys as a result of its vertical integration".

21 You see all of that?

22 A Yes.

23 Q If you could read, please, the section under "Likelihood of competition developing in the
24 future", which is the following two paragraphs. (After a pause):

25 A Yes, I think this is what I was referring to earlier about forward-looking assessment of SMP.

26 Q Nowhere here at all is Ofcom contemplating substantial new entry in to the wholesale
27 AISBO market?

28 A Yes, it refers to "prospect of widespread entry appears to Ofcom to be limited". That is
29 what is said, yes.

30 Q If we could then turn back, please, to Ofcom's objectives in imposing the Condition HH3.1.
31 We find those under "Aims of regulation", p.160 and it begins at para.7.8. Do you have
32 that?

33 A Page 160, yes.

34 Q Yes. You may wish to consult the statement, but it may be possible to do it more quickly if

1 I could just summarise for you and you can see whether you agree or not. Ofcom's
2 objectives in the 2004 Statement, in relation to wholesale AISBO, were focused on
3 intervening to promote downstream competition in the retail market because otherwise it
4 considered there was a risk of BT exercising its market power in the upstream market to
5 charge excessive prices.

6 A I think it is worth just a little explanation around that.

7 Q Do you agree with that proposition?

8 A Well, I think I should put it in context first and then I'll turn to your specific question. So
9 there are two types of competition which will promote competition to the benefit of retail
10 consumers. One is what one might call access-based competition. This is providers
11 operating only in the downstream market, who are purchasing wholesale inputs from, in this
12 case it is likely to be, BT. I say access-based competition because they are reliant upon the
13 provision of access by BT. Another type of competition is what one might call vertically
14 integrated players. These are people who are present in the downstream market but also
15 present in the wholesale market. So they may, for example, be self-supplying at the
16 wholesale level as well as being present in the downstream market. So both those types of
17 competition are beneficial. Often there can be a tension between those two in terms of the
18 nature of regulation, and so a balance may need to be struck between them. This is one of
19 the types of trade-offs I refer to in my witness statement, a trade-off within the category of
20 dynamic efficiency between different types of dynamic efficiency. So without regulation at
21 the wholesale level you might not get any of the access-based competition if BT, for
22 example, didn't even supply the wholesale inputs and they weren't available on a sufficiently
23 ubiquitous basis from other providers. In terms of the rationale for implementing regulation
24 at the wholesale level, clearly enabling and promoting access-based competition is an
25 important focus, yes, but I think there are other considerations as well because there are
26 other types of competition that can benefit consumers.

27 Q Certainly there is no mention in this discussion of the aims of regulation that one of the aims
28 of the obligation that was being imposed was to allow prices above cost so as to promote
29 new entry into the wholesale market, was there?

30 A This doesn't refer to that, but the general issue is related to the problems that result from the
31 existence of SMP in the relevant wholesale market, and that SMP at the wholesale level
32 doesn't restrict or distort competition in the relevant downstream market. So it falls within
33 that general category. I agree with you, this paragraph (I have only read this para.7.10) does
34 not explicitly refer to the points you just mentioned.

1 Q Turn on, please, to para.7.59. This is the paragraph that I went to in opening with the
2 Tribunal. One of the things that Ofcom is concerned about that it discusses here is BT's
3 incentives as regards the introduction of new products. Do you see that?

4 A Yes: "...new service is innovative and thus warrants a different regulatory approach."
5 Q Yes. So what we see – and you may just wish to refresh your memory of para.7.59 first – is
6 a tiered approach. Perhaps you would like to read it and we can then go through it. (Pause
7 to read)

8 A Yes.

9 Q So the first possibility that is being canvassed here is that this new service may be so limited
10 it falls outside the market entirely?

11 A Yes.

12 Q So by definition obviously Condition HH3 would not apply, so we do not need to worry
13 about that. The next possibility is that the service falls within the market but nonetheless it's
14 sufficiently innovative that Ofcom might exercise its discretion to disapply the charging
15 principle as set out. You will recall Condition HH3.1 allows Ofcom to decide on a different
16 approach if it wanted to?

17 A Yes.

18 Q Just to be clear, just so there is no doubt about it, you are not suggesting that your DSAC
19 approach is a disapplication of the pricing test in HH3.1, are you?

20 A No.

21 Q So then we have the third category which is that BT could potentially argue for a higher rate
22 of return if a particular new service justified it. You see that? This is in sub 3.

23 A So it is sub 3. This seems to be referring to the fair bet issue.

24 Q Exactly.

25 A " Ofcom will need to take account of the risk of the new service failing and the lost
26 investment that would result " so that suggests to me this is referring to what I think Ofcom
27 in the Determination called the fair bet issue, and it's been called that in other documents.

28 Q It says:
29 "In determining whether a charge is not cost orientated, Ofcom would consider
30 whether the expected or achieved return on capital was excessive. In making this
31 assessment, Ofcom will need to take account of the risk of the new service failing
32 and the lost investment that would result."
33 It is clear, is it not, from this section, and also perhaps if I could ask you to look at para.7.61
34 first. (Pause to read)

1 A Yes.

2 Q What Ofcom is contemplating is that BT will be able to come to it and seek to justify a
3 higher rate of return for particular services on the basis that they are new services?

4 A This is para.7.59 that you're referring to?

5 Q A combination of 7.59 and also 7.61 where it talks about
6 "The potential for a degree of flexibility envisaged in the approach to the recovery
7 of cost of capital recognises that some investments will carry a higher degree of
8 risk than others ..."

9 A Sorry, could you repeat your question, please?

10 Q Yes. The question was that what Ofcom was contemplating here was that BT could
11 potentially come to it to seek to justify a higher rate of return than its ordinary WACC on
12 the basis that the service was a new service.

13 A So that seems to be what's contemplated in 7.59(iii).

14 Q And Ofcom are not suggesting anywhere here that BT should get a blanket high rate of
15 return way above its WACC across all Ethernet products, irrespective of whether they are
16 new services or not?

17 A I don't think that issue is dealt with here. By which I mean I don't think it's commented on
18 either way.

19 Q But that is what DSAC provides, is it not? It does provide a rate of return at substantially
20 above the WACC.

21 A Relative to the fully allocated costs, yes, if that's the right measure of cost which would
22 depend on the question that was being addressed.

23 Q We then come on to the famous paragraphs under the title "Responses to the draft
24 notification - basis of charges obligations", do you see those?

25 A Yes.

26 Q This section was in fact only included to deal with a response to a point raised by certain
27 CPs, was it not? We see that because it says "Responses to the draft notification".

28 A Yes, it refers to those suggestions, yes. Whether it was only included for that reason, I don't
29 know, but it refers to those responses.

30 Q Perhaps it would be helpful just to clarify the point. May we go, please, to p.83 in the clip
31 of documents that I gave you, just very briefly. That is back in tab 39 of AD2 for the
32 benefit of others. Do you have that, the document headed "Review of retail leased lines
33 explanatory statement and notification"?

34 A Yes.

1 Q I am grateful. Then if we turn over we have the extract that is the equivalent of the extract
2 from the part of the Decision that we are looking at, but we see (if you just want to skim)
3 there is no section dealing with the imposition or otherwise of the basis of charges
4 obligation because at this stage no-one is suggesting it.

5 A Sorry, you referred to basis of charge obligation, did you mean that?

6 Q Sorry, to a price control. No-one had suggested it.

7 A There is nothing in this extract, and if you are telling me it wasn't elsewhere in the
8 document I'm sure that's right.

9 Q So we can infer that the reason why Ofcom included that paragraph on which you rely is
10 because it was responding to requests/suggestions from CPs that there should be some kind
11 of price control. That is why it is there.

12 A I'm not disputing that.

13 Q If we go on to para.7.67 we see, in common with some of the earlier passages we looked at,
14 that the objective is to promote downstream competition whilst allowing BT a fair rate of
15 return that it would expect in a competitive market. Do you see that?

16 A Yes, I see that. It looks like this is referring to the access-based competition that I was
17 referring to earlier.

18 Q You are not aware, are you, of anywhere in the 2004 statement that suggests that Ofcom
19 wished to allow BT an opportunity to recover its common costs multiple times? I think you
20 have given me an answer to that, which is it is what you infer but it is not set out anywhere.

21 A I'm sorry, could you repeat the question?

22 Q Yes. There is nowhere in the statement at all that suggests that Ofcom was intending to
23 allow BT to recover its common costs multiple times?

24 A I don't believe there's any statements to that effect, no.

25 Q Could we then move back, please, to para.6.91. What we have been looking at so far is the
26 cost orientation obligation imposed on Ethernet. Now we are going to look at and compare
27 that with what Ofcom did in relation to PPCs where it did impose a price control. You see
28 the title there "Price control on PPCs"?

29 A Yes.

30 Q The price control that Ofcom imposed on PPCs was based on FAC, was it not?

31 A That's my recollection, but is there a specific?

32 Q If we turn on to para.6.101 under discussion of "Level" we see a reference back to the PPC
33 Phase 2 Direction. Do you see that?

34 A Yes.

1 Q We have already seen in the Phase 2 Direction that the approach that the Director was
2 taking then was based on CCA FAC?

3 A Yes, that accords with my recollection.

4 Q Then, if you could turn, please, to paras.6.107 and 6.108 and read those paragraphs to
5 yourself, please. (Pause to read)

6 A Yes.

7 Q Here, in the context of PPCs we see a discussion by Ofcom of a comparison between price
8 controls and cost orientation. Do you agree with that?

9 A Yes.

10 Q Nowhere does Ofcom say that --

11 A Or rather it seems to be comparing cost orientation alone with cost orientation plus a price
12 control. "It is unnecessary to apply a price control in addition".

13 Q There is no suggestion here, is there, that the difference is that cost orientation obligations
14 allow you to price above cost?

15 A No, that is -- it depends what you mean by "cost", but it does not discuss that question
16 reflecting the market circumstances to PPCs.

17 Q What it does discuss is the fact that, and this is really I suggest the key difference between a
18 price control and a cost orientation obligation, is that (1) the price control imposes a
19 forward-looking constraint and a cost orientation obligation is assessed on the basis of
20 outturn costs and that has different implications for the productive efficiency incentives.

21 A I think I need to set that in context. What seems to be being compared here is cost
22 orientation on its own, where given that the market conditions supported the imposition of a
23 price control in principle that cost orientation, as with the earlier document that Mr.
24 Pickford was taking me to, and I think I made this point earlier, that cost orientation
25 condition would be performing effectively two roles, one of allowing bounded flexibility
26 and the other in terms of imposing a tight restriction on prices through a cost plus or rate of
27 return regulation. So what it seems to me this is comparing is effectively, what it seems to
28 be saying is a price control is in principle appropriate and, in effect, it is discussing the
29 advantages of a price cap compared to a rate of return regulation or a cost plus approach to
30 implementing that price control or tight restriction on PPC prices. In that context, I agree
31 that an advantage of the price caps over rate of return regulation is that it has superior
32 productive efficiency incentives, which is one of the points I make in my witness statement.

33 Q If you go on, please, to para.6.130. This is Ofcom's conclusion on the imposition of the
34 price control, and if you could read para.6.130, please. (After a pause):

1 A Yes.

2 Q So Ofcom is saying here that without a price control there is a risk that BT will be able to rise
3 above the competitive level?

4 A Yes.

5 Q The competitive level it is talking about here must be the CCA FAC standard, because that
6 is the level at which it is setting the price?

7 A Again I think I should put a little bit of context around that. So this is talking about the PPC
8 price control, which I think must be the terminating segments price control. As that was a
9 relatively mature market and the judgment of what a competitive price level is is extremely
10 difficult, and there is a very significant risk of what one might call "regulatory failure", in
11 other words that the regulator would misjudge exactly what the competitive price level was.
12 How difficult both the extent of the risk of that regulatory failure and potentially the
13 consequences of that regulatory failure are going to be different in different market
14 circumstances. In market circumstances which are dealing with a more mature market, the
15 competition has had the opportunity to develop and the products are more mature; the
16 conditions of cost and demand are perhaps more stable or predictable. Whilst there is still a
17 significant risk that the regulator, in trying to identify the competitive price level, will get it
18 wrong it is a lesser risk than in an immature market. The consequence of getting it wrong
19 are also likely to be less severe. There still will be consequences but they are likely to be
20 less severe because in an immature market competition, both investment by the regulated
21 firm and the development of new competition, is less developed. The nature of the
22 regulation is likely to have a stronger influence on that market at an early stage of
23 development. It could allow it to flourish or it could stifle it at birth inadvertently through
24 regulatory failure. So you need to see the point about FAC being used as a proxy for
25 competitive level in that context, in the context of regulatory failure and that varying
26 depending on market circumstances. Yes, it is true that when Ofcom decides that it wants to
27 set a price control, it is appropriate to set a price control, whether that is a rate of return
28 price control or a price cap, effectively Ofcom has to take a view on what the competitive
29 price level is in order to judge the appropriate level at which to set that price control. Given
30 the risk of regulatory failure I have referred to, effectively what I would expect a regulator
31 to be doing would be essentially balancing, in the overarching frame, it would be balancing
32 the risks of market failure and regulatory failure. So, in other words, if there is a very
33 serious concern about market failure then you might be willing to tolerate more regulatory
34 failure because the balance was overall beneficial. But in different market circumstances,

1 and again there is a different balance between market and regulatory failure, a regulator may
2 come to a different conclusion. So these are core areas where regulatory judgment needs to
3 be exercised and there are clearly going to be different ways of striking those balances.
4 Different people might take different views of that, and different market circumstances
5 would support different types of balance between these considerations. So with that
6 important context, perhaps you could just repeat your question so that it is clear that I have
7 directly answered your question?

8 Q The question was that Ofcom were equating the competitive level with the CCA FAC level
9 in this context.

10 A Yes, so in this specific context, given these market conditions and the appropriateness of
11 imposing a price control, that was set, as we have discussed, based on the cost standard of
12 CCA FAC, I agree.

13 Q I am going to put it to you, purely for completeness, but you have already given your
14 answer I would suggest, that where the competitive level is also referred to in the context of
15 the AISBO market, that is the same competitive level, and your answer presumably is, "No,
16 it is not. The context is different"?

17 A The context is different. The risks of regulatory failure, of identifying the competitive price
18 level are more severe because it is an immature market at this point in time. We see in the
19 2008 Market Review and the 2009 Leased Line Charge Control, it was a more mature
20 market and a similar approach was taken as was taken to PPCs terminating segments in
21 2004. But the market circumstances of Ethernet, WES and BES in 2004 were different,
22 were relatively immature, and therefore it is much less clear what the competitive price
23 level will actually be.

24 Q If you could turn, please, back for comparison to para.7.61, we are now back in the basis of
25 charges obligations in relation to AISBO. Okay?

26 A Yes.

27 Q Here Ofcom is talking about allowing BT a fair rate of return that it would expect in a
28 competitive market. You have just answered one of the questions that I was going to ask
29 you about this, but the competitive market that is being hypothesised at this point, at 7.61, is
30 a competitive wholesale AISBO market, is it not? A wholesale AISBO market?

31 A "... proportionate response to the extent of competition in the markets analysed...", yes, I
32 think that must be referring to the wholesale markets. Those are the ones that are analysed
33 in this context.

34 Q When it talks about the competitive level here, you are surely not suggesting that

1 "competitive" means contestable? That any level of return up to the return that would be
2 earned if prices were SAC would be legitimate?

3 THE PRESIDENT: Sorry, when you say when it refers to the competitive level here?

4 MR. PICKFORD: I beg your pardon, I slightly misstated it. The fair rate of return which it
5 would expect in a competitive market. I beg your pardon. So when it is referring to the
6 return that would be expected in a competitive market, what is being contemplated is not
7 merely a contestable market, because under the theory of contestability you could price all
8 the way up to SAC in that market, it must be contemplating something different from that?

9 A I am sorry, just one point of clarification. You talk about "fair rate of return", but there are
10 two considerations that are going to influence the competitive level, or at least two. One is
11 the appropriate rate of return necessary for the investment taking account of the risk and,
12 indeed, the fair bet consideration, if those are relevant, and, second of all, the extent of
13 common cost recovery or the appropriate cost standard. So your question was, when it talks
14 about the extent of competition or the ----

15 Q When it says that Ofcom is going to allow BT a fair rate of return which it would expect in a
16 competitive market ----

17 A I am sorry, could you just point me to exactly where it says that?

18 Q Yes, of course. At the bottom of para.7.61 we see Ofcom's explanation of why it thinks that
19 cost orientation condition is justifiable.

20 THE PRESIDENT: Have you got that?

21 A I have that, yes. So I am not sure that is referring to the cost standard. As I said, there are
22 two elements. There is the rate of return and there is the appropriate cost standard FAC
23 which is sometimes used when setting a price control, for example, or other standards such
24 as DSAC, and it is an interpretation of cost orientation. This seems to me to be dealing with
25 the first element of that, which is the rate of return. I am not sure this is dealing with the
26 question of what the appropriate cost standard is. The competitive price would include both
27 elements, but this particular point about rate of return seems to be dealing with those risk
28 adjusted cost of capital and fair bet considerations.

29 MR. PICKFORD: If Ofcom is telling BT that it is going to be allowed a fair rate of return that it
30 would expect in a competitive market, it must have in mind implicitly some kind of
31 charging standard that it associates with that.

32 A Yes, so what that would be would depend on the circumstances. So in this particular case,
33 my understanding given para.7.63, which you have not taken me to yet (I assume you are
34 going to), but given that important paragraph, my interpretation is that standard would be up

1 to DSAC in these specific market circumstances, given what is said, that a price control is
2 not necessary.

3 Q So your evidence is that BT was being told that a fair rate of return was anything up to the
4 return generated by DSAC across all Ethernet products?

5 A So I'm not saying that from that specific paragraph. The critical paragraph that to me
6 implies that that is the case is para.7.63. So perhaps I should talk about that. Paragraph
7 7.63, which is the paragraph explaining Ofcom's decision not to impose the price control
8 and giving reasons, what it says is

9 "Ofcom is of the view that it is not currently necessary to impose a price control on
10 AISBO products ..."

11 Then it talks about the AISBO market is at a relatively early stage of development, which is
12 very important in terms of the relevant market circumstances. Then it says:

13 "... it is necessary to give time for the effects of the cost orientation obligation to
14 impact on the competitiveness of the market before considering whether a price
15 control is necessary."

16 My understanding of what that means is about allowing the competition in the wholesale
17 market to develop under the restrictions imposed by cost orientation and not a price control,
18 and then: "The need for a price control will be considered when the market is next
19 reviewed."

20 So I think I have given my interpretation of that about allowing competition to develop in
21 the wholesale market, and to relate that to some of my earlier points. This is again an area
22 where there is clearly regulatory judgement involved. In particular, Mr. Pickford has taken
23 me to the importance of access-based competition and the importance of regulation in the
24 wholesale market to support access-based competition and I entirely agree that is important.
25 That is clearly an important purpose of the regulation imposed in the AISBO market. But
26 that's not the only consideration. Even if there were substantial barriers to entry – and when
27 we looked at the SMP assessment it talked about the prospects for large-scale entry being
28 limited – that was Ofcom's market analysis. But that doesn't mean there's no prospect for
29 entry or no possibility of entry. And, particularly given the fact it was an immature market,
30 it's particularly important to think about what prospects there might be for entry and also, in
31 fact, the prospect that Ofcom might slightly misjudge how large or small those prospects
32 are. These are difficult areas of regulatory judgement because there are trade-offs being
33 made between these different types of competition. In this case, a particularly important
34 aspect is the trade-off between what I referred to earlier as access-based competition and

1 vertically integrated competition. That, it seems to me, is what balance and trade-off that
2 Ofcom is striking here by deciding not to impose a price control because although that will
3 be better for access-based competition because they have a lower price that they will be
4 paying for the wholesale service, it's likely to have an impact on the prospects for the
5 vertically integrated type competition, the entry at the wholesale level and it is likely to be
6 providers who are also present at the retail level.

7 So I think it may also be worth commenting on the alternative interpretations of this
8 paragraph that have been --

9 Q Mr. Myers, you are obviously very keen to give the explanation that you are prepared to
10 give, but if I could ask the questions.

11 A Yes, sure, as long as I will have an opportunity (because I think it is a very important point)
12 to explain why my interpretation I think is superior to the alternatives that have been put
13 forward.

14 THE PRESIDENT: You will be. Ofcom's counsel will have a chance to re-examine you and put
15 any further points to you. We will give you that opportunity in due course. I think just
16 concentrate on answering Mr. Pickford's questions.

17 A Right, thank you.

18 Q Mr. Pickford, are we still in this part?

19 MR. PICKFORD: We are still in this document. We have probably got about another five
20 minutes to go in this document.

21 THE PRESIDENT: Yes, we do need to take a break. We have held off for a bit.

22 MR. PICKFORD: If we can continue for five minutes, or have a break now, whichever the
23 Tribunal would like.

24 THE PRESIDENT: If it is only five minutes why do you not complete this document and then we
25 will break.

26 MR. PICKFORD: Staying in this section, one of the reasons that we saw that BT had market
27 power at the wholesale level was because of its large economies of scope?

28 A Yes.

29 Q They obviously arise because there are large common costs?

30 A Well, if you like, the two are flip sides of the same coin.

31 Q Exactly.

32 A Just to complete the point, common costs arise as a consequence of the existence of
33 economies of scope and vice versa.

34 Q If BT were to be subject to genuine competitive pressure in, say, the Ethernet market, it

1 would not realistically come from a firm which just provided Ethernet services, would it?

2 A I think that's all a matter of degree. There are different types of potential competitor
3 operating across different product sets. In fact, this really links to the importance of and the
4 relevance of not imposing a price control. Imposing a price control at FAC is essentially
5 saying that an entrant is only going to be able to come in if it has similar economies of
6 scope to BT. It has to broadly match BT's economies of scope. As we have seen,
7 economies of scope were very large for BT, and I think the wording was "substantial
8 advantage" for BT. So it's quite unlikely that there would be entrants satisfying that
9 criterion, whereas there may be entrants with some economies of scope of their own – they
10 operate across a set of services, or in the case of Ethernet, that would be a limited set of
11 services. They would struggle to compete at the prices set at the level of FAC and would
12 probably require prices set somewhat above that level because they have far less economies
13 of scope than BT. So whether that competition by competitors with fewer economies of
14 scope than BT is desirable or not again goes back to a question of regulatory judgement,
15 because on the one hand if they have less economies of scope than BT then there is what is
16 sometimes called a static or a short-term inefficiency because they are a higher cost provider
17 at the margin than the incumbent. So if they are taking business away from the incumbent
18 it's increasing the total cost to society of delivering a set of services. In a very mature
19 market a regulator might take the view that actually that was the appropriate way to
20 proceed, because competition had been fully developed. But in many other contexts it's
21 very typical not to take that view; to take the view that competition, even if it's statically
22 inefficient in the short term, is likely to bring longer term more dynamic benefits, and that
23 looked at over the long-term, which in this context would be a longer period of time than a
24 single market review, is it overall beneficial. So there are questions of regulatory judgement
25 there which it seems to me go to the heart of some of the trade-offs that Ofcom is making
26 underlying its decision here not to impose a price control.

27 Q Sir, if that would be a convenient moment?

28 THE PRESIDENT: Yes. We will say until 11.30.

29 Adjourned for a short time

30 MR. PICKFORD: Mr. Myers, if we could move on, please, to Chapter 10.

31 A Yes.

32 Q You were taken to this Chapter yesterday by counsel for BT. I think we can jump straight
33 to para.10.12, and that deals with the cost accounting obligations for Kingston, and we see
34 that they apply, *inter alia*, to the AISBO market. We see that - yes?

1 A Yes.

2 Q Here Ofcom explains that, as is previously, CCA FAC can in certain cases be a good proxy
3 for LRIC plus mark-ups. So this is in the context of a cost orientation condition, and the
4 cost accounting obligations that are necessary to comply with it. A relationship being
5 drawn between that and CCA FAC.

6 A Are you asking me to comment on that?

7 Q Yes, that is correct?

8 A Yes, it is. I think, if we look at the three sets of markets that are being referred to, the retail
9 market, that's low bandwidth leased lines, the wholesale market for traditional interface low
10 and high bandwidth, and the AISBO market. Those are markets that will have different
11 market circumstances associated with them. I presume Kingston had SMP in all three, but
12 in terms of the considerations that I was talking about before in terms of the maturity of the
13 market, there are very significant differences. So that would be one observation, that it does
14 refer to CCA FAC as a good proxy for LRIC plus mark-ups, which seems to be referring to
15 the specific form of LRIC plus equal proportionate mark-up as we discussed before. I
16 imagine that that would be the appropriate interpretation of cost orientation effectively as a
17 price control perhaps for the first two. It's not clear to me whether it also applies to the
18 third. As I understand it, the other consideration that may be relevant is that Kingston didn't
19 have a LRIC model, didn't have the capability without developing - expending cost and
20 developing a LRIC model, unlike BT. Although I don't have direct knowledge of this, I'm
21 aware of some arguments that Ofcom has put forward to suggest that that's relevant to the
22 interpretation of this paragraph, that effectively, as I understand it, Kingston was suggesting
23 that it was willing to restrict itself to CCA FAC because it preferred that to the cost of
24 having to build, develop and have verified a LRIC model which could establish the DLRICs
25 and DSACs which would otherwise have allowed them more pricing flexibility.

26 Q We can put this away now, and you may be able to answer the next question without taking
27 out a bundle, but it depends on how much you recall about the RFS and the part of the RFS
28 that we see that sets out information under the heading "Cost orientation".

29 A I recall some of it, but it depends on your question.

30 Q All right, if we could pick BT8, tab 17, please, that is the simplest thing. Could you go back
31 to p.41 that we were looking at previously. Do you have that page?

32 A Yes. Sorry, which year was this? This is 2007/08?

33 Q This is 2007/08. We see under the title "Cost orientation" that the first thing that BT
34 provides to enable assessment of compliance with its cost orientation obligation is the FAC

1 data - do you see that, "FAC, see section 6"?

2 A Yes, I see that's listed under the heading of "Cost orientation".

3 Q It has to do the same for all other services subject to cost orientation as well. There is no
4 magic in this particular page?

5 A I imagine not.

6 Q The FAC figure is the only audited piece of information that is required by Ofcom for
7 monitoring compliance with the cost orientation obligations, is it not?

8 A As I understand it, that is correct, the FAC is audited information and the DLRIC and
9 DSAC information is not audited.

10 Q That would indicate that is highly important in the scheme of information necessary to
11 consider BT's compliance?

12 A I'm not sure it would indicate that necessarily. I think that would kind of depend. The fact
13 that it's audited whereas there's other unaudited information may go to the question of the
14 level of scrutiny and verification doesn't, of itself, define the level of importance of that
15 information. For example, typically in these matters there are considerations of relevance
16 and reliability, and one's thinking about the usefulness of any specific costs data. So FAC is
17 audited, which goes to the question of reliability, but that still leaves open the question of
18 relevance, so it doesn't seem to me that the fact that it's audited itself defines the level of
19 importance of FAC or the nature of its role in the interpretation of cost orientation.

20 Q Could we go, please, now back to the clip of documents. What we have done so far is,
21 firstly, we saw the documents prior to the 2004 statement, now we have just been looking at
22 the 2004 statement and now we are going to go on and look at some of the documents post-
23 dating the 2004 statement. So we have been going in chronological order. Could we go,
24 please, to p.89, it is in tab 39 of AD2, it is the clip.

25 THE PRESIDENT: The ERG Common Position?

26 MR. PICKFORD: Correct, thank you, Sir.

27 A Yes, I have that.

28 Q Ofcom is a member of the ERG, is it not?

29 A Yes, at the time. I'm not sure it exists any more, but at the time, yes, it was. It
30 Q It was at the time?

31 A It was at the time, yes.

32 Q Could we turn, please, to p.92.

33 A Yes.

34 Q Could you read, please, the final paragraph, the context of the relationship between IC, SAC

1 and FAC?

2 A Yes.

3 Q We see the same sentiment being expressed as we saw in an earlier document that I took
4 you to in the second and third sentences, that if incremental and common costs are more
5 than recovered, that is a failure of demonstrating cost orientation?

6 A I'm sorry, which specific sentence are you referring to?

7 Q I will read it. It says:
8 "In a situation where the prices of more products and services are based on IC
9 (including a mark-up for common costs), this first test alone ..."
10 It is the test that we are used to seeing.

11 A Yes.

12 Q "... is not sufficient to demonstrate cost orientation. For example, if all services
13 were set at SAC, incremental and common costs would be more than recovered."

14 A Yes, I'm agreeing with you, but just to clarify, this is talking about the individual service,
15 incremental and stand-alone costs and combinatorial tests. This is not, as I understand it,
16 talking about DLRIC and DSAC because those are at least primarily UK developed costs
17 measures and they're not necessarily used in other European countries.

18 Q As I put before, the same point applies. What it is saying here is that revenues that exceed
19 incremental and common costs is a failure of cost orientation, and, subject to your
20 qualification, I think you agree with that?

21 A (After a pause) Well, I guess it implies that. Is that what you're asking me, what this text
22 says?

23 Q Yes. I was asking you whether you agreed with my understanding of it, and I think you
24 have given your answer.

25 A Yes, whether there are other factors that will also be relevant, I guess it doesn't say. There's
26 a sentence which says that the first test alone is not sufficient to demonstrate cost
27 orientation, and then it gives an example, so I guess I would agree with your interpretation.

28 Q Thank you. You can put AD2 away, I think. You have read Ofcom's Defence obviously?

29 A I have.

30 Q And indeed its skeleton argument?

31 A I have.

32 Q Were you given an opportunity to comment on each of those documents before they were
33 served?

34 A Sorry, I'm just trying to recall. I didn't play a large role in either document because I was

1 primarily focusing on my witness statement and preparation for this hearing, and the joint
2 experts' meetings and the joint experts' statements. As I recall, I did have some opportunity
3 to comment on some parts of the Defence and skeleton argument.

4 Q I am assuming that in so far as they relate to matters that you have either given evidence on
5 or are within your expertise - I am not asking you that vouch for anything that is said in
6 relation to the law - you agree with what is said in those documents?

7 A In general. As I say, I didn't necessarily review every aspect that might fall within the
8 categories you have identified.

9 Q Perhaps if we could just check one point and we can see whether you do or do not agree
10 with it. Could you pick up Ofcom's skeleton, which should be in a separate skeleton
11 bundle, and you will find it at tab 4.

12 THE PRESIDENT: Respondent's skeleton argument.

13 A No, I don't seem to have it. It doesn't seem to be in this bundle. It has other people's
14 skeletons, it doesn't have Ofcom's. (Same handed) I think I have been given a copy now,
15 yes, I have respondent's skeleton argument.

16 MR. PICKFORD: I am grateful. Would you turn, please, to p.56. At sub-para.(b) Ofcom is
17 dealing with a point about the WLR ISDN2 dispute, which is also known, I think, as the
18 *Energis* dispute.

19 A Right.

20 Q What it is saying is that the reason why WLR ISDN2 dispute was determined on the basis
21 of LRIC plus EPMU is that the departure from the usual DSAC was notified in advance to
22 obviously in particular BT, but more generally the world at large. Are you familiar at all
23 with the *Energis* dispute.

24 A Only in the highest level terms. I'm not actually familiar with the detail.

25 Q Could we look at it briefly. It is contained in ST1, volume 4. We have rather confusing ----

26 THE PRESIDENT: Do you want the Determination or ----

27 MR. PICKFORD: That is the resolution of dispute. I am going to the dispute first and then ----

28 THE PRESIDENT: It is also in BT14, I think. We have had it before in BT14.

29 MR. PICKFORD: I think it may be a different one.

30 THE PRESIDENT: I think there are two *Energis* disputes.

31 MR. PICKFORD: It is a different dispute. There are two *Energis* disputes, and I am going to go
32 a different one. It is ST1, volume 4, tab 20. We see in para.1 that the context is that there
33 was an alleged overcharge by BT for wholesale business ISDN2 line rental - do you see
34 that?

1 A Yes.

2 Q Can we turn to Ofcom's conclusions which begin on p.14, section 3. We see at para.45 that
3 Ofcom says:

4 "In deciding whether or not BT's WLR charges have been set in accordance with
5 SMP service condition obligation Ofcom has considered the application of SMP
6 condition AA10 and where appropriate SMP Condition AA3. SMP Condition
7 AA3 states:
8 'that each and every charge offered, payable or proposed for Network Access
9 covered by Condition AA1(a) is reasonably derived from the costs of provision
10 based on a forward looking long-run incremental cost approach and allowing an
11 appropriate mark up for the recovery of common costs including an appropriate
12 return on capital employed'."

13 So that is the same formulation as we have in the present case?

14 A Yes.

15 Q Ofcom goes on, if you could read para.46, please, to yourself?

16 A Yes.

17 Q So what we see there is Ofcom interpreting that obligation as LRIC plus EPMU?

18 A Yes, in the context of SMP being entrenched and the product not being a new one, which I
19 think goes to my point about market circumstances.

20 Q If we go, please, now to the document which imposed the obligation that we have just been
21 construing, we find that in bundle AD1, tab 2.

22 A I am sorry, which tab was it?

23 Q It is tab 2, p.21.

24 A "Review of the fixed narrow band wholesale exchange line call origination" ----

25 Q That is correct.

26 Q Can you go, please, to p.21, we see half way down "Basis of charges" - do you see that?

27 A Yes.

28 Q If you would like, please, to familiarise yourself with that section and then
29 "Communications Act test", so that takes you to half way down the next page. (After a
30 pause)

31 A Yes.

32 Q Thank you. Will you turn back, please, now to para.5.22. We see that BT and Kingston are
33 being told that they need to charge on the basis of LRIC plus an appropriate mark-up for
34 common costs, including an appropriate return on capital employed. There is no particular

1 indication given, here or in any of the sections that you have looked at, that that should be
2 interpreted as a departure from a DSAC norm, is there?

3 A It doesn't look like it. So the wording in para.5.22 seems to mirror the wording of the
4 condition. I'm not sure if there's any context around. At the end of 5.26 it refers to LRIC
5 plus mark-up. It could mean a number of things. I don't know whether there's anything
6 else, but looking only at this text I agree it's not self-evident, shall we say, that it's departing
7 from DSAC.

8 Q Likewise, they have nothing to indicate that. It is the flipside of the same question: there is
9 nothing to indicate that it is going to be LRIC plus EPMU, is it?

10 A Yes, I think that's covered by my previous answer. Unless there is some other text that's
11 relevant, as I said, it's not self-evident that this means LRIC plus EPMU on the basis of this
12 text alone.

13 Q OK. Could we go please to ST1 volume 6 tab 25. You should have there the review of the
14 fixed narrow band services wholesale market. Do you have that?

15 A Yes.

16 Q Could you go right towards the end of that to p.334 Annex 14 Guidance on Interpretation of
17 Cost Orientation?

18 A Yes.

19 Q We see 14.1:

20 "This Annex provides guidance in interpretation of the basis for charges
21 obligations being imposed on BT and KCOM in several markets ...

22 14.3:

23 Below, we distinguish three different cases where a basis of charges condition is
24 imposed in this statement."

25 Then you see the first category which I am not going to concentrate on, but just so we see
26 what they are, the first one is: "Charge controls and cost orientation as complementary
27 conditions." Do you see that?

28 A Yes.

29 Q Obviously, that is not our case because we do not have a complementary charge control; we
30 have a charge control on its own in our case, do we not? Sorry, we have a cost orientation
31 obligation on its own in this case. I beg your pardon. Then if we turn over the page we see
32 a new title: "Cost orientation as a form of regulation in the case where a charge control is
33 deemed a disproportionate response". Do you see that?

34 A Yes.

1 Q Could you read, please, the whole of para.A14.5. (Pause to read)

2 A Yes.

3 Q You already told us that the Ethernet market in 2004 it was relatively new?

4 A Yes.

5 Q So there were relatively limited volumes of products being sold, relative to expectations as
6 to the future?

7 A Sorry, could you repeat the question?

8 Q There were limited volumes of products being sold in 2004 relative to expectations that one
9 might have about the future development of the market?

10 A Sorry, just to clarify that, I think you're saying that the expectation was that the volume of
11 Ethernet circuits would grow very substantially, yes I agree.

12 Q It would have been difficult to estimate in 2004 what the efficient FAC would look like in
13 three or four years' time, would it not, in those circumstances?

14 A Well, I don't know. That requires a somewhat more detailed understanding. I mean,
15 whenever one forecasts costs there's always a risk of forecast error. Where volumes are
16 expected to grow that clearly gives rise to the potential for misforecasting the extent of the
17 volume increase, the pace at which volumes grow, and that could have a significant impact
18 on costs which depends on the facts, on the extent to which costs vary with volumes –
19 sometimes called the cost volume relationships. So yes, there's a potential for forecast error
20 but how severe that was I'm not sure I'm in a position to judge without – because it is very
21 fact specific to the nature of costs and how costs change with volume, for example.

22 Q I am asking now. Although I have taken you to this document and I have been making
23 some comparisons, I am actually asking now about the Ethernet market. The Ethernet
24 market in 2004, because we were expecting substantial increases in demand, it would have
25 made imposing a charge control very difficult, would it not, because it would have been
26 difficult to estimate what the efficient FAC was three or four years out?

27 A So that would have been an issue if a charge control was deemed to be appropriate, then that
28 question would have arisen. How difficult it would be I'm not sure I'm in a position to
29 comment on. I can see that it would give rise to the potential for forecast error. There is
30 always potential for forecast error; there might have been greater forecast error here than the
31 norm, but how serious an implication that would have in terms of – essentially this goes to
32 the question I was referring to earlier about regulatory failure, that wider issue. So the
33 question would be how serious is that risk of forecast error, not just in terms of volumes but
34 in terms of the implications for costs which, as I say, depends also on how costs are affected

1 by volumes. Also, what would be relevant to the question would be the consequences of
2 getting it wrong. But I think you put to me a rather specific proposition. Could you just
3 repeat it?

4 Q Yes, the proposition was in the context of Ethernet in 2004, the fact that it was a relatively
5 new market with relatively small volumes which were expected to grow very substantially,
6 would have made it very difficult to impose a charge control because that would have
7 required you to estimate three or four years out?

8 A I think to answer that question very directly, I don't know if it would have made it very
9 difficult; it would clearly have been an issue that would need to have been tackled if a
10 charge control had been considered appropriate. How difficult it would be I don't think I'm
11 in a position to judge without a much more fact-intensive analysis of costs and how they
12 vary with volumes.

13 Q You say it would have needed to have been considered if a charge control had been
14 considered appropriate.

15 A Yes.

16 Q I would suggest that it would be one reason why a charge control might be inappropriate:
17 precisely because you know that it would be very difficult to do.

18 A In general that's a possibility, that is a regulatory judgement that might be made. I don't
19 believe that fits with the (since you refer to Ethernet) Ofcom reasons as stated in para.7.63
20 in the 2004 Statement. That says it is not necessary to impose a price control. If Ofcom's
21 reason for not imposing a charge cap, a price cap, had been the difficulty in forecasting
22 costs – and indeed I see that this paragraph that you referred me to here says: "Where there
23 is persistent SMP and a charge control would usually be appropriate" – well, Ofcom in 2004
24 in relation to Ethernet said a charge control price control was not necessary. That doesn't
25 seem to fit that criterion. There's no discussion of a price cap is appropriate in principle but
26 it's difficult to forecast costs and therefore we're not going to impose a price cap; we're
27 going to take a different approach and adopt a tight restriction on prices and costs recovery
28 through cost orientation. There's nothing in the paragraph that suggests anything along
29 those lines. I would suggest the fact it says a price control is not necessary actually is
30 inconsistent with the interpretation you've just put to me.

31 Q Will you go, please, to the cost orientation review which is contained in BT32 tab 2, 2(iii).

32 A Yes.

33 Q The cost orientation review. Turn, please, to para.3.81.

34 THE PRESIDENT: It is tab 2(iii)?

1 MR. PICKFORD: Yes.

2 THE PRESIDENT: What is the year?

3 MR. PICKFORD: This is -

4 A It was this year.

5 THE PRESIDENT: 2013?

6 A Yes.

7 MR. PICKFORD: Could you turn, please, to p.40. We see on the previous page there is the
8 subtitle "Our analysis on the approach to setting cost orientation obligations" and then we
9 have a subtitle "With a charge control" and then another subtitle on p.40 "Without a charge
10 control". Do you see that?

11 A Sorry, the heading of "Without a charge control", yes.

12 Q Then it says:

13 "We said above that we might use a cost orientation obligation where we do not set
14 a charge control, but that this might be in fairly limited circumstances. One
15 possibility is imposing cost orientation in the context of a prospectively
16 competitive market (see paragraph 2.88 above). A second possibility, which we
17 focus on below, is the case of cost orientation as a 'fallback', where the
18 circumstances suggest a charge control is appropriate in principle but we believe
19 that there is sufficient uncertainty over costs that to do so would risk regulatory
20 failure through setting a control that was too tight or too loose."

21 So I think the point I am going to put to you is one that you already answered through the
22 previous question. You would obviously accept this. You would say that it is all context
23 specific and you would give the answers that you have already given?

24 A Yes, I would accept that that is an example. It doesn't use the term regulatory failure, but
25 that links to the concept I was referring to before, and it is referring to circumstances where
26 the risk of a regulatory failure of forecasting is sufficiently severe that actually it's
27 inappropriate to impose a price cap. In terms of the relevance to the 2004 Market Review as
28 regards Ethernet services, this possibility is in the case where circumstances suggested a
29 charge control was appropriate in principle. I think I have explained my view that I don't
30 believe those were the circumstances that applied in that 2004 Market Review.

31 Q You have given that view very clearly. Thank you. If you turn over to para.3.85, we see
32 that in this context it is suggested:

33 "...we may consider it more appropriate for prices across the group of services within
34 the control to be close to FAC rather than all being able to be set at DSAC".

1 So that is actually, on its face, extremely like the test that Sky and TalkTalk are proposing,
2 is it not?

3 A Yes, it has that in common because the situation that is being envisaged is Ofcom thinks a
4 price control is appropriate in principle. The risk of forecast error is too serious to impose a
5 price cap, an RPI -X price cap, so the interpretation of cost orientation is performing the
6 function of a price control, in terms of restricting prices and cost recovery, and obviously
7 price controls typically work across a basket of services. So it is mirroring a price control,
8 obviously not all the aspects of a price control, but it is performing the function of a price
9 control that, I would say, it is a price control. It is just a different type of price control, a rate
10 of return cost plus price control compared to a price cap price control.

11 THE PRESIDENT: I think it is explained, is it not, in 3.82 to 3.84, just above?

12 A Yes, I am grateful. That refers to "baskets of services" in 3.84.

13 Q It says there are two reasons why it would take a different form. There are two different
14 circumstances where you might have a cost orientation, which is the fall-back, as I
15 understand it. 3.82 is referring to the fall-back cost orientation which we were taken to in
16 3.82, namely where circumstances suggest a charge control is appropriate in principle but
17 there is a risk of regulatory failure, that is the point you were making. Then I think, have I
18 understood this correctly, it is saying in that case Ofcom might want the cost orientation
19 obligation to take a different form, and then it gives two respects in which it might do so?
20 Is that right?

21 A 3.83 is referring to the regulatory failure issue, or the one I have characterised as regulatory
22 failure, and essentially why not imposing a price cap, and 3.84 is saying, effectively in the
23 circumstances where cost orientation is being used as a fall-back to a price cap, when there
24 is too much regulatory failure associated with a price cap, a different cost standard of DSAC
25 might wanted to be used. It refers then to baskets of services which is then developed in
26 3.85 in terms of "appropriate for prices across the group of services within the control to be
27 close to FAC rather than being able to be set at DSAC".

28 MR. PICKFORD: And para.3.83 is setting out circumstances which directly parallel those which
29 are experienced in 2004 for Ethernet, because there was uncertainty over costs which made
30 setting a charge control with confidence difficult?

31 A That may be. I do not know because, as far as I am aware, the 2004 Market Review
32 document does not say that and, as I have explained, I think that what is said about the
33 reasons for not imposing price control is not the reason given in 3.83 here. Actually, as I
34 have said before, it says it is not necessary to impose a price control and then it refers to the

1 development of competition. So that seems to be a different reason for not imposing a price
2 control from the one being described here.

3 Q You can put away that bundle and pick up Core Bundle E and go to Tab 14. So this is the
4 2009 Leased Line Charge Control, so this is when a charge control was in fact imposed on
5 AISBO. If you can go, please, to para.3.168, which you should find on external p.26. Do
6 you have that?

7 A Yes, I have that.

8 Q We see:

9 "To determine BT's base year costs, we had to decide upon the appropriate cost basis
10 to use. In the December Consultation we noted that BT's SMP obligations provide a
11 useful reference point, as they require that the charges for its regulated services are
12 required to be reasonably derived from the Long Run Incremental Costs ('LRIC') of
13 providing that service allowing for an appropriate mark-up, including recovery of any
14 common costs. However, the way in which we can arrive at a view of these costs"
15 [that is referring back to these costs under that Condition] "depends on the cost basis
16 used. There are two main methods considered".

17 Then we see LRIC + EPMU and CCA FAC. Can you see that?

18 A Yes.

19 Q So in this passage, obviously I quite accept we are in the context of imposing a charge
20 control where ultimately Ofcom does use CCA FAC, but in this particular passage it is
21 equating Condition HH3.1 with LRIC + EPMU or CCA FAC, is it not?

22 A When it refers to BT's SMP conditions, that is a backward looking reference, is it, to the
23 existing SMP conditions in place? Actually maybe that does not matter, in fact.

24 Q They explain that the condition they are concerned with is "its regulated services are
25 required to be reasonably derived from the Long Run Incremental Costs of providing that
26 service allowing for an appropriate mark-up, including recovery" ----

27 A Which mirrors? You are saying that mirrors the wording in the Condition HH3.1?

28 Q That mirrors the wording in the obligation we are concerned with.

29 A Yes, it does appear to say that. It does not make a lot of sense to me but it does say that.

30 Q If we could move, please, to a new issue, which is allocative efficiency, so we can put away
31 Core Bundle E and, in preparation for where we are likely to be going, pull out Core Bundle
32 D, please. If you can turn, please, to Tab 1.1, so it is your joint report with Dr. Houppis and
33 Dr. Maldoom.

34 A Yes.

1 Q If you go, please, to Question 2, which is on p.11, you say, in response to the question:
2 "Is it likely that the prices of WES/BES services led to allocative inefficiencies".
3 And you say: "Unclear".

4 A Yes.

5 Q So am I right that on your case it would have been equally unclear whether prices that were,
6 say, £100 million over DSAC would cause allocative inefficiencies when Condition HH3.1
7 was imposed? You are saying it is unclear now whether the prices of services that were
8 charged for WES and BES led to allocative inefficiencies. Would that also have been
9 unclear in 2004, looking ahead?

10 A I am sorry, putting myself back in the position in 2004?

11 Q Yes, put yourself back in 2004 and you say to yourself, what if BT were to charge the prices
12 that we know were in fact charged in this case, which are some above DSAC, some below
13 DSAC, would that be allocatively inefficient? Since you say it is unclear today, would you
14 also say it would have been unclear to you in 2004?

15 A That is quite a complicated question so I think I just need to reflect on it.

16 Q Of course. (After a pause):

17 A Can I just clarify, are we comparing that to an alternative or are we comparing it to the --
18 because I think it is kind of ----

19 Q We are simply answering the question that you answered in 2, but we are doing it as if you
20 are now looking forward anticipating the same prices but asking yourself that question in
21 2004. In 2013 you asked yourself the question, "Is it likely that the prices that we actually
22 saw in the market led to allocative inefficiencies?", and you said it was unclear. So all I am
23 asking you is if you put yourself back into 2004 and asked yourself the question, "What if
24 BT priced in that way, would that lead to allocative inefficiencies?", and I am suggesting
25 that on your logic you would presumably also answer "unclear"?

26 A I think you need to have an alternative in mind. So if we take this question in isolation, the
27 alternative would be allocative inefficiencies compared to the optimal set of prices, because
28 any deviation from the optimally efficient set of prices would involve allocative
29 inefficiencies. So if I am comparing, taking your question, compared to the optimal set of
30 prices, yes, that would have been unclear because it is extremely difficult to identify what
31 those optimal set of prices are.

32 THE PRESIDENT: What I do not quite understand, Mr. Myers, is your reasoning in your
33 comment there under "Unclear", because you say, after some general statements about the
34 complications, you then say in the last sentence:

1 "The use of DSAC as a ceiling for individual charges recognises the risk of regulatory
2 failure...", and so on.

3 But this is a question, I think, about the actual prices that BT charged, some of which, of
4 course, were found to be substantially in excess of DSAC.

5 A Yes, that is right. They were found to be in excess of DSAC, but I think what this is --
6 Perhaps I should check what the specific paragraphs are in my witness statement just to
7 remind myself.

8 MR. PICKFORD: That is in the same bundle at Tab 13.

9 A Thank you. (After a pause): I think one of the sources of complication here is that there are
10 two comparisons that may be going on. One is comparison of the actual prices to the
11 optimal, the allocatively efficient, the optimal set of prices and that's very difficult to
12 determine. The other thing that's going on – because this whole report is about the
13 comparison between the DSAC test and the FAC test and that's what I think the last
14 sentence is alluding to - is that compared to the FAC test the DSAC test allows greater
15 scope for BT to set different charges, and that recognises the risk of regulatory failure, so
16 you can identify and impose tight restrictions on prices, i.e. in this case the FAC test, if
17 that's intended to achieve allocatively efficient prices. So the last sentence was more about
18 the comparison between the DSAC test and the FAC test.

19 Q The difficulty I have is that the question that you are being asked is whether the actual
20 prices led to allocative inefficiencies and you say it is unclear, and yet you evidently
21 believed that it was appropriate to at least restrain prices from going above DSAC because
22 that was the basis of your entire intervention in this case.

23 THE PRESIDENT: The same applies to Dr. Maldoom's answer in fact. Whether you are
24 answering the question: is it likely that the prices actually charged led to allocative
25 efficiency, or a different question: is it likely that prices charged at DSAC would lead to
26 allocative efficiencies? You see the difference?

27 A I see the difference.

28 Q That is a different question.

29 A It is a different question.

30 Q Reading Dr. Maldoom's answer, he also seems to be addressing that question. So I am
31 slightly confused. Perhaps we should not worry about Dr. Maldoom. The question is what
32 question are you answering, as you understood it?

33 A I am trying to recall exactly. Sorry, the distinction between the actual prices – so, I think I
34 was in fact answering (and I can see it departs from the precise wording here) but the

1 previous question talks about prices up to DSAC. I think I may have interpreted this
2 question as also relating to that: the permitted prices under Ofcom's approach.

3 Q Yes, so if you now address the other question, which is: the actual prices found to be
4 charged, which were of course sometimes in breach of (as you found it) the condition
5 because they were above DSAC. Is it likely that would lead to allocative efficiency?

6 A It's a very complicated question to establish that. Clearly, the higher the prices the more
7 likely it is. Some of the prices were very substantially in excess of DSAC, so that would
8 materially increase the risk. I'm slightly cautious about drawing a definitive conclusion
9 because it's just a very complicated question what the allocatively efficient set of prices are.
10 But clearly there's a significantly greater risk of that with prices as high as they were
11 actually set which, in some cases was a very long way above DSAC.

12 MR. PICKFORD: If we could break it down into some sub-topics and go through it on that basis.
13 I would like to start with the level of prices. I think we can agree that in relation to
14 allocative efficiency there are essentially two considerations. There is the overall level and
15 then there is the structure. Do you agree with that?

16 A Yes.

17 Q If we just go to 4.1 which you will find on p.7 of the joint statement. This is points of
18 agreement:

19 "BT offers a range of services that share f/c costs with cost oriented services. If BT
20 sets the prices of a sub-group of these services at DSAC, with the rest at FAC, then
21 BT will achieve multiple recovery of f/c costs, as the DSAC of a service is
22 typically significantly higher than its FAC. This will not achieve the maximum
23 level of short-run allocative efficiency possible: if the price of the services priced
24 at DSAC was lowered to FAC, then this would be expected to lead to an increase
25 in demand and an improvement in allocative efficiency through an increase in
26 consumption resulting from a lower overall level of prices."

27 So that is our starting point and that is obviously common ground?

28 A Yes.

29 Q As I did with Dr. Maldoom, I would like to consider three or possibly four categories of
30 different types of market that share significant common costs with wholesale Ethernet
31 services. I will run through what they are, and then you can tell me whether you are broadly
32 happy with them. The first is those that are subject only to cost orientation obligations; the
33 second is where there are price controls in place (with or without cost orientation
34 obligations); the third is those that are competitive. I suggest that is the three main

1 categories, and then arguably there might be a fourth category that you could argue existed
2 which was where there was SMP but without any particular cost controls.

3 A I think that fourth category exists, although SMP is perhaps not precisely the right term to
4 use. So we would be talking about unregulated markets in the sense of not covered by SMP
5 conditions, we will say?

6 Q Yes.

7 A That set of markets is likely to fall into two categories. Many of those markets are likely to
8 be competitive, but I think there is likely to be a set of markets in which BT has market
9 power but it hasn't been subject to the ex-ante process of market review and SMP
10 assessment. I think there is an example of that relevant to BT's termination of non-
11 geographic calls. I believe this is in the bundle. It is a market in which Ofcom conducts a
12 Competition Act investigation, there were not SMP conditions in place. I think the period
13 covered overlaps with the period that we are considering here. Ofcom made a finding of
14 dominance for BT in that market. This is the NCCN 500 Competition Act case, which I
15 believe is somewhere in these bundles. So that's an example of a market where BT had
16 market power but it wasn't an SMP market, so it would fall into this fourth category.

17 Q There is an obligation on Ofcom, is there not, to consider key markets in which it may or
18 may not need to make SMP findings, and it does so. It either considers that there is SMP or
19 there is not SMP. So the ones where it considers that there might be market power but it
20 does not make an SMP finding are a relatively small residual category?

21 A There are many markets that are not subject to market review, and that would cover a large
22 amount of revenue. I don't know the precise numbers. The criteria for the markets subject
23 to market review – I'm trying to remember exactly what they are, but it's not about key
24 markets as I recall; it's about, although clearly many key markets do fall into that category,
25 markets where ex ante regulation is appropriate. So I think it's a question of degree. I think
26 it would be wrong to suggest that the markets outside of the market review process are
27 small or unimportant, but I certainly agree that many of the most important markets where
28 BT would have persistent dominance, would be covered by the market review process.

29 Q In particular, the markets that share common costs, significant common costs, with
30 Ethernet?

31 A That's such a wide range of services that I think that would cover markets in all four of these
32 categories.

33 THE PRESIDENT: Does it really matter, Mr. Pickford, for your questioning, quite how you
34 define the fourth category? Mr. Myers has defined it slightly differently as being an

1 unregulated market where BT has SMP.

2 MR. PICKFORD: I think it probably does not, sir.

3 THE PRESIDENT: I would not have thought it matters, does it?

4 MR. PICKFORD: Could we move on, then. You have not sought to dispute Mr. Robinson's
5 evidence that for Ethernet products, namely WES, BES and mainlink, BT recovered in the
6 order of £230 million more than its FAC from external customers during the dispute period?

7 A No, I understand that's correct.

8 Q Likewise, you have not sought to dispute TalkTalk's evidence advanced during the disputes
9 that in other markets where BT is also subject to SMP conditions in the same form as
10 HH3.1, BT recovered in the order of £360 million above its FAC?

11 A Just to be precise about that, I think that's in your first category where there is only a cost
12 orientation obligation in place.

13 Q That is correct.

14 A Yes, I don't dispute that number. But I think that's over a three year period.

15 Q It is over the same period as the disputes.

16 A OK, I thought it was a three and a bit year period.

17 Q I beg your pardon, that is over a three year period.

18 A Yes.

19 Q So on the basis of the only evidence that we have got (and it is obviously somewhat
20 approximate) we are aware of over-recovery above FAC of up to about £600 million. That
21 is what we are aware of in terms of evidence.

22 A We are aware of an excess of FAC. I think it is inappropriate, in my view, to call that over-
23 recovery; it is simply an excess over FAC. That would be of the order of £200 million per
24 annum, and I think one of the points of the note that Ofcom submitted yesterday, I think the
25 very first note I was taken to by Mr. Pickford this morning, set out the scale of the fixed and
26 common costs that are relevant to Ethernet services. I think that puts in context the size of
27 that £200 million. That £200 million is still a relatively small proportion of the £2.2 billion
28 of fixed common costs which obviously would be expected to be recovered across a very
29 wide range of BT services.

30 Q We know that for services which are subject to a charge control prices are generally
31 regulated by reference to FAC? I think that is common ground there?

32 A Yes, that's correct.

33 Q In relation to competitive markets, BT has not provided any evidence that it was under-
34 recovering relative to FAC in the order of £600 million, or indeed any other amount. There

1 is simply no evidence from BT on that?

2 A That's correct, I have not seen any evidence.

3 Q In any event, in a competitive market the price is set by competition and not by BT, is it not,
4 by assumption?

5 A That's right, the price is set by competition and, as I was describing earlier in the context of
6 the difficulties of identifying a competitive price level and the risk of regulatory failure and
7 Ofcom, when setting a price control typically use FAC as a kind of proxy for that, but I
8 mentioned earlier the significant risk of regulatory failure. There's no particular reason to
9 believe that the competitive price level in those competitive markets would be FAC. It
10 could be above it, it could be below it.

11 Q But changes in what BT could recover in markets where BT does have SMP should not
12 substantially affect the price in a competitive market, because by definition it is not BT that
13 is setting that?

14 A Yes, that is right but that seems potentially going more to the question of structure and I
15 thought we were talking about the question of level.

16 Q Okay, we will take it a step at a time. If you allowed below cost pricing in competitive
17 markets to offset above cost pricing in SMP markets, that could distort BT's incentives in
18 both types of market, could it not?

19 A This is quite a difficult problem, I think, if one is trying to construct an overall aggregate
20 test or consider the question of recovery across a wide range of services. I think we are on
21 the topic of allocative efficiency but actually these points are going well beyond allocative
22 efficiency. They are talking about trade-offs with other types of efficiency, productive and
23 dynamic.

24 Q I hesitate to interrupt, but in terms of the discussion, if we were able to partition it to
25 allocative efficiency and then I will come onto dynamic efficiency.

26 A If you wanted me to confine myself to the question of allocative efficiency ----

27 Q Initially, but we will come onto that.

28 A -- initially, then the answer to that question is, purely looking only at allocative efficiency,
29 and I am not suggesting that this is necessarily the right answer overall, but purely for the
30 purposes of allocative efficiency, you would take whatever the cost recovery was across all
31 of these markets. The reason for that goes to the nature of what allocative efficiency means
32 in this context. So the starting point for that is that the most allocatively efficient outcome
33 is where all prices are set equal to marginal cost. That is, if you like, the starting point for
34 allocative. However, that does not allow a firm, which has its economies of scale and

1 scope, which, as we know, is very important here, it means they would not recover all their
2 costs. They would not recover any of their fixed and common costs if all prices were set
3 equal to marginal cost. So that is not the concept of allocative efficiency we are using. We
4 are using what is sometimes called "constrained second best allocative efficiency", which is
5 that the allocative efficient prices have to be a mark-up over marginal costs and those mark-
6 ups are determined by reference to demand conditions (that is sometimes called Ramsey
7 pricing if we are talking at the retail level anyway), so the demand conditions in different
8 markets would determine issues about structure, but as regards the overall level the mark-
9 ups should be taken as a whole, should allow the firm to recover all of its costs, including a
10 reasonable rate of return, but no more. So inherent to the concept of allocative efficiency
11 that is being used here, is that the issue of level is about all of, in this case, BT's services or
12 at least all of those that share these fixed and common costs. There are good reasons, if one
13 was applying a test of this nature, to exclude services, in particular the price control
14 services, but that is where you are going beyond allocative efficiency. So I have been asked
15 to confine myself to allocative efficiency, so in respect of competitive services, narrowly,
16 from the point of view of allocative efficiency, you should include competitive services.
17 The distortion you are talking about is a concern because if you did use that test then it
18 would cause problems as regards potential for below cost anti-competitive pricing in a
19 competitive market or, indeed, under-performance, even absent anti-competitive behaviour,
20 simply under-performance or, indeed, over-performance (in other words, earning at a less
21 than a normal rate of profit in a competitive market because BT was simply not a good
22 competitor in that market), or the alternative of BT being -- I am sorry, it is the low cost that
23 is perhaps more relevant here. I will come to the other in a second. So that is the concern.
24 The concern is if you employed an aggregate test that it would allow BT to offset its under-
25 performance in a competitive market by pricing higher in an SMP market. That is a
26 problem relating to dynamic efficiency, for example. It goes beyond just the narrow view
27 of allocative efficiency. But there is a problem, so that is a problem, and therefore that
28 potentially leads to an argument for excluding competitive services when thinking about
29 overall recovery of a firm. But the problem is that you are losing relevant information and
30 the other scenario, I was starting to talk about before, then becomes relevant. If you then
31 exclude the competitive market then the risk is that the competitive price level is, well, let's
32 say it is one of the possibilities, it is below FAC, as we know it could go the other way - it
33 could be above - but if it was below FAC then you would be potentially compromising
34 allocative efficiency by restricting the remaining set of services to FAC because it would

1 not be taking account of the fact that the competitive services were recovering less than
2 FAC, even if BT was performing to a reasonable standard. So, I apologise, that was a
3 slightly rambling answer, but, just to summarise, if one looks at it narrowly from the point
4 of view of allocative efficiency, you should include all services. That does raise problems
5 when one starts to bring in other considerations, and there is a potential concern whichever
6 way one goes. Ideally what one would like to do would be to identify the competitive price
7 levels in those markets and one that took out the effect of any pricing distortions, but that is
8 obviously extremely difficult to do.

9 Q Mr. Myers, subject to that qualification -- because that has been very helpful but I certainly
10 do not want you to give that answer again ----

11 A I do not think I want to give that answer again!

12 Q -- or we simply will not be able to get through -- subject to what you have said, and parking
13 for a moment the structure of prices, which we are going to get onto, if the prices of all cost
14 orientated services were on average at FAC rather than DSAC, that would lead to an
15 improvement in allocative efficiency?

16 A That would only be the case if one knew that all of the other services -- that that did not
17 prevent BT from recovering all of its costs across all of the other services, taking into
18 account where the level of cost recovery might reflect BT's perhaps superior performance in
19 some of these competitive markets. So there is certainly that risk, and I hope I have been
20 clear in recognising there is that risk, but I do not think one could definitively assess that
21 without looking at the full range of services and, given the scale of the fixed and common
22 costs here and the range of services across which they are recovered, that is a difficult
23 question to address.

24 Q I think your answer is that, subject to the point that you made about competitive markets,
25 you do agree that if we reduced all prices from DSAC to FAC that leads to an improvement
26 in allocative efficiency?

27 A No, that is not quite right. As I say, if one is purely looking at allocative efficiency one
28 should consider all services, not just the competitive but all four categories.

29 Q I think you have answered that question. Thank you. If we look at the structure of prices,
30 and the structure issue is about allowing prices to contribute to common costs by different
31 extents relative to one another, is it not?

32 A Yes, that is right.

33 Q It is the point that you were explaining about Ramsey pricing. I would like to break it
34 down, as I did with Dr. Maldoom, into intra-Ethernet flexibility and then flexibility between

1 Ethernet and other groups of services, if I may. So first I am looking at the intra-Ethernet
2 issue and, in this context, flexibility is the ability to vary the relative contributions that
3 different Ethernet products make for a given level of total recovery, is it not?

4 A Yes, that is right.

5 Q Under Sky and TalkTalk's approach, any individual price can be set up to DSAC just as
6 under Ofcom's approach.

7 A Yes, that is right.

8 Q But the difference obviously of our approach is that for every price that leads to revenue
9 above FAC there needs to be some corresponding offsetting below FAC so that we hit FAC
10 overall.

11 A That is right.

12 Q Since any price can be set up to DSAC if necessary, there is no loss in flexibility between
13 the contributions to common costs made by different Ethernet services relative to one
14 another. You can have whatever relative distribution you want. You then just scale it to
15 make sure that ultimately you recover FAC overall?

16 A Yes, I agree with that.

17 Q If we could go on then to inter-group flexibility, so now we are looking at the Ethernet
18 market as a whole relative to other markets, such as ISDN. The principle that I ----

19 A I am sorry, this is just between cost orientated services, are we talking?

20 Q This is between cost orientated services, yes.

21 A Simply between cost orientated services. All right.

22 Q Because in relation to price controlled services, the prices there are set by the price control.

23 A That is right, but if you are going to ask me questions purely confined to allocative
24 efficiency then actually you should take account of those prices. I am not suggesting that
25 that is the right conclusion when one brings in other considerations of efficiency because, as
26 you say, you could set a price control and then you start allowing offsetting against that you
27 are undermining the price control. But that is for reasons of productive and dynamic
28 efficiency.

29 Q As a pragmatic regulator, we obviously have to take a bounded approach.

30 A But the point I am making ----

31 Q Do we not?

32 A You do have to take a bounded approach but the point I am making is that you are making a
33 trade-off though. You are making a trade-off between different types of efficiency and you
34 are trading off potentially compromising allocative efficiency for the purpose of

1 maintaining incentives for productive and dynamic efficiency. I would agree that if one was
2 doing a test of this type then, taking account of that trade-off, one should exclude price
3 control services. The point I think I am making is that that does involve a trade-off between
4 these different types of economic efficiency and it does involve a degree of regulatory
5 judgment, although perhaps a relatively clear one in this particular case.

6 Q Let us look at the inter-group flexibility issue and we are looking at different groups of cost
7 orientated services. Okay? Just as I explained in relation to prices within Ethernet, you can
8 do the same thing in relation to groups of services, can you not? You can set some below
9 FAC on average and some above FAC on average, so that across the whole set you recover
10 your FAC?

11 A I think this is, I think the term has been used "escape clauses", the initial test applies at the
12 level of, say, the WES/BES services and then the first "escape clause" is that if that is above
13 FAC then BT might be able to justify that if it could show that it was pricing below FAC by
14 similar amount on another service that was subject only to a cost orientation obligation. I
15 think ISDN 2 is an example that has been given. So, yes, I understand that is part of the test
16 that is being proposed by Sky and TalkTalk. Essentially what that is doing is that is
17 extending the rate of return regulation so that it encompasses the full set of cost orientated
18 services, where this escape clause is triggered. I am sorry, I had another point. (After a
19 pause): I am sorry, I am perhaps a little tired. I cannot quite recall my other point. Perhaps
20 it will come to me.

21 THE PRESIDENT: The question you were asking, Mr. Pickford, you explained what you were
22 addressing on inter-group flexibility, but going back to your previous question?

23 MR. PICKFORD: My question, I think, was that under Sky and TalkTalk's test, just as for within
24 the Ethernet set of services, you can apply the same principles effectively across different
25 groups. It is the same idea, that you set different groups either above or below FAC,
26 ultimately so that you recover FAC overall. That is obviously something that is possible on
27 our test, and I think when you gave your answer you agreed?

28 A I'm agreeing with that. I've recalled the other point I was going to make, which was the
29 extent to which BT is able, in practice, to do that may depend on its ability to forecast FAC
30 to a sufficient degree of accuracy and/or depending on how much leeway is given as regards
31 this escape clause in terms of the non-mechanistic application of the FAC test. I think,
32 Mr. Harrison, you made the point - I cannot remember which day it was - that it is not just a
33 question of the outturn of £million excess or shortfall of the revenue relative to FAC. It's
34 not simply a question of the price of a set, it's also a function of the volumes and new

1 services, etc, etc. There is a range of considerations that will go into that £million figure,
2 whether that's in excess of FAC or below FAC. So there could be complications or practical
3 issues to be dealt with which could impact on the extent to which, in practice, BT would be
4 able to do that offset, but I accept the general point that you're putting to me, which is that it
5 does allow for a degree of pricing one higher and the lower, which is relevant to the
6 structure of pricing.

7 Q I am grateful. Can we move on to dynamic efficiency, and the framework for the analysis
8 of that ----

9 THE PRESIDENT: Just before you do that, that is a significant topic, is it not?

10 MR. PICKFORD: It is, yes, Sir.

11 THE PRESIDENT: Would it be sensible to break now and come back at five to two?

12 MR. PICKFORD: Yes, Sir.

13 THE PRESIDENT: That will give you a clean start on dynamic efficiency. You are looking a bit
14 concerned, we will say at ten to two.

15 MR. PICKFORD: Thank you.

16 (Adjourned for a short time)

17 MR. PICKFORD: Mr. Myers, could you please look at p.20 of your joint note, which is tab 1.1
18 of CBD, we were in it earlier on.

19 A Yes, I have it.

20 Q We see here the framework for analysis of the issue of dynamic efficiency, and it breaks
21 down into three. We have got incentives for BT to undertake efficient investment and
22 introduce new innovative services, we have got the effect on downstream competition and
23 incentives for efficient investment by other CPs, and then we have got incentives for
24 efficient new upstream entry to compete against Openreach in the provision of wholesale
25 WES and BES services - that is right?

26 A That's right. Perhaps I could just clarify. When I referred this morning to the distinction
27 between the two types of competition, the access based competition and the vertically
28 integrated competition, you'll see here that there's a footnote at the bottom of this page
29 which says that we use the term downstream to mean 'access' based competition, and that's
30 a footnote to the meaning of "downstream competition". So what's referred to in this note
31 as downstream competition means "access based competition", and the vertically integrated
32 type of competitor, competition, is in this third category where you have entry in the
33 wholesale market.

34 Q Thank you. In order for BT to undertake efficient investment - I will start with BT, if I may.

1 A Right.

2 Q In order for BT to undertake investment and provision of services that are subject either to
3 price controls or to cost orientation, BT needs to recover the costs it incurs, including return
4 on capital employed, that reflects appropriately the risks that BT faces when investing in
5 those services - that is right, is it not?

6 A That's right. The risk, and there's also that question, which is a related but slightly different
7 issue.

8 Q Therefore, what we need to do is to determine what the relevant cost of capital is that
9 appropriately compensates for the risks that are being faced?

10 A Yes, that's a significant part of the question. There's also the question of the cost standard,
11 because that can also affect the returns that BT would get. So there's both those questions.

12 Q The cost then feeds in ultimately to the potential return that BT can ----

13 A No, there are two distinct questions - sorry, feeds into the returns. Sorry, maybe I
14 misunderstood you. So there's a rate of return. The rate of return, the weighted average
15 cost of capital and the 'fair bet' question, that's the rate of return. There's a question of the
16 appropriate costs standard. Both of those together feed into the return that BT would earn
17 on an investment.

18 Q You will recall that I went through with Dr. Maldoom the discussion in the 2004 LLMR
19 statement of whether Ofcom was going to allow BT a higher cost of capital to reflect in
20 particular the riskiness of Ethernet as compared to other aspects of BT's business - do you
21 recall that?

22 A That was in the section - was that the same text we looked at earlier?

23 Q No, we have not looked at that. If you want to go to it, we will go through it briefly. If we
24 could pick up the statement in the Final Determination, CBB, and if you go, please, to
25 para.9.229, you will see the title, "Rates of return on capital employed and the appropriate
26 WACC" - do you see that?

27 A The heading, yes.

28 Q I took Dr. Maldoom through this and I was assuming that you might recall it?

29 A I do, in fact, recall it, having seen this is what you're referring to.

30 Q There is an analysis here by Ofcom of whether it should allow a higher weighted average
31 cost for capital for the specific risks faced by BT, and Ofcom's essential answer, to
32 summarise, is that it was not going to allow a higher WACC because there was insufficient
33 evidence that the risks were any different to the rest of BT, and indeed many of the
34 investments that were made were sunk investments that BT had to make in any event to do

1 the rest of its business?

2 A Yes, I would agree with that.

3 Q Also, Ofcom looked at 'fair bet' considerations, at para.9.238 and following, and again it
4 came to the same conclusion that there was no need to increase the returns allowed to BT to
5 compensate for that either?

6 A Yes, I agree.

7 Q So I would suggest, and I think I know your answer given the answer that you gave three or
8 four questions ago, there is no need to add a further margin on to the normal margin that is
9 allowed for BT in its WACC to reflect any other risks that were faced by BT in the Ethernet
10 market, because your analysis in these paragraphs already shows that you have addressed all
11 the relevant risks and they feed through into the WACC?

12 A Yes, in terms of the rate of return or the 'fair bet' question, I would agree with that. As I
13 said earlier, there's still the question of the relevant cost standard, which is not quite the
14 same question.

15 Q Let us look at your table of returns on capital employed, please, which you included in the
16 hand up yesterday. We can put core bundle B away, and could you take out, please, bundle
17 AD2, and go to tab 36. I would like to look at table 2, please. This is the table that actually
18 uses the Ofcom model that Ofcom used to calculate the overcharge?

19 A That's correct.

20 Q We see from this table that if all of BT's prices had been set at DSAC - so that is the limit of
21 what it would have been allowed to do, obviously - it would have earned a return on capital
22 employed of 36 per cent over the years that are considered?

23 A Yes, that's right.

24 Q Indeed, that is, in fact, the return on capital employed that it did make, albeit obviously
25 some of its prices were above DSAC and some were below?

26 A Yes, I think you're referring to the actual ROCE column, which, as you say ----

27 Q Column 2.

28 A Column 2 - which, as you said, includes the effects of overcharging and also includes the
29 effect of BT choosing to set some prices below DSAC.

30 Q That rate is over three times BT's weighted average cost of capital, is it not?

31 A That rate is, yes, which includes the effects of overcharging, relative to the DSAC test, I
32 mean.

33 Q The one in column 1 is also the same figure?

34 A Oh, sorry, you're referring to that figure, were you?

1 Q Yes.

2 A So that's correct, that is about three times BT's weighted average costs of capital, but is of
3 course a hypothetical. I accept the point you're making, which I think is a hypothetical,
4 which is that if BT had set all of its prices at DSAC, and I agree under a mechanical
5 application of a DSAC test that would be permitted. However, that's not what BT actually
6 did, and there are some prices that were set materially below DSAC.

7 Q And indeed, as we saw, some that were above ----

8 A Some were above.

9 Q -- and it hit the same return?

10 A Well, yes, but I think that's the reason for including columns 3 and 4 which take out the
11 effects of overcharging. I would say if you're trying to look at the underlying BT wholesale
12 profitability with the application of Ofcom's approach to overcharging, i.e. the DSAC test,
13 then column 4 is the most meaningful of these four.

14 Q If we look at them one at a time. We will look first at column 3 and then we will go on to
15 column 4.

16 A Column 3, yes.

17 Q In column 3 you have removed the overcharge in relation to external products?

18 A That's correct.

19 Q You cannot reasonably calculate a return on capital employed assuming in your favour that,
20 for all prices in excess of DSAC, BT complied with the test but for all actual prices charged
21 by BT that were below DSAC, it kept them at the levels below DSAC?

22 A I think the answer to that is that's not what it's seeking to represent. It's not seeking to
23 represent BT's actual charges, because that is obviously in column 2. What it's seeking to
24 represent is taking out the effects of overcharging in BT's charges.

25 Q So what it does is, in anything that was above the DSAC limit it cuts down to DSAC - is
26 that correct?

27 A Yes, that's correct.

28 Q And anything that was below the DSAC limit it leaves exactly as it was?

29 A Yes, as BT set those charges.

30 THE PRESIDENT: Can you just help me to understand: "External revenue" means what?

31 A "External revenue" means the prices, payments made by CPs, whereas "Internal revenue" is
32 sales of wholesale services by BT to itself.

33 MR. PICKFORD: The evidence we heard from BT is that BT did not understand condition
34 HH3.1 to mean a DSAC constraint. So it is somewhat meaningless, is it not, in column 3 to

1 assume that BT, in your counterfactual, would have set its prices so as to comply with a
2 DSAC constraint ----

3 THE PRESIDENT: When you say they did not understand it to mean a DSAC constraint, are you
4 saying there was evidence that they understood cost orientation to be a different ceiling
5 from DSAC?

6 MR. PICKFORD: We have heard some evidence on that. There has been evidence from
7 Mr. Coulson that no one in BT that he spoke to even knew why they were reporting DSAC.

8 THE PRESIDENT: There was some evidence from Mr. Coulson that they did not seem to
9 perhaps apply any particular cost orientation in determining their prices.

10 MR. PICKFORD: Exactly.

11 THE PRESIDENT: But I do not think there is evidence that they understood the condition
12 HH3.1, those who looked at it, as meaning the ceiling that is a different ceiling from DSAC,
13 is there?

14 MR. PICKFORD: Sir, I do not believe there has been any evidence that BT understood condition
15 HH3.1 to mean DSAC.

16 THE PRESIDENT: We will have to check on that. I thought that that was what they understood,
17 even though they did not apply it.

18 A To answer your question, I don't think it's meaningless at all. I think it's a reflection of
19 prices that were actually set. So in that respect it reflects factual information on taking the
20 effects of overcharging. How you interpret that - there may be additional considerations to
21 bring to bear on how you interpret that, but that doesn't make it meaningless. That makes it
22 actually quite meaningful, but there may be slightly different interpretations depending on
23 what question you're trying to answer, and what other considerations you think are relevant.

24 MR. PICKFORD: Your final ROCE calculation deducts the internal overcharge as well. So this
25 is effectively the overcharge that BT overcharged its own downstream operation?

26 A Yes. It's not formally an overcharge, but yes, it's the excess. It's analogous to the
27 overcharge on external revenue.

28 Q Exactly, and that has the effect of transferring returns that Openreach did, in fact, make -
29 that Openreach made - out of Openreach as if it had not made them to another part of BT?

30 A Yes, it has that effect, and I think the issue would be - what you'd want to look at would
31 depend on the question you're trying to address. Column 4 would be relevant for some
32 purposes and a different approach to it might be relevant for other questions.

33 Q In the context of the kind of returns that the DSAC limit allows Column 4 is not very
34 helpful, is it?

1 A No, I think it is actually the most relevant because otherwise you are inflating the rate of
2 return by including BT's wholesale profitability and prices to itself that were above DSAC,
3 so you are including the effects of, in a sense, BT overcharging itself, even though there is
4 not a formal finding. So if you are trying to understand BT's wholesale profitability, subject
5 to the constraints imposed by the Ofcom test, it seems to me that that is a relevant thing to
6 look at.

7 Q But BT's wholesale profitability did include its overcharges, did it, to whoever they were
8 made?

9 A I think we are probably agreeing that BT could take that profitability, either at the wholesale
10 level or the downstream level ----

11 Q But it did take it at the wholesale level.

12 A I do not think -- I am sorry, in its accounts it shows up at the wholesale level. Where it
13 actually took it is actually a question of interpretation because simply, of course, it is just a
14 paper transfer from one part of BT and another -- whether it is from retail to wholesale or
15 from wholesale to retail -- and therefore the issue is what is the best measure of profitability
16 for the question you are trying to address. If you are trying to assess BT's wholesale
17 profitability subject to the DSAC test, I would suggest that Column 4 is actually the most
18 meaningful because otherwise it is inflated by excesses over DSAC on internal revenue.
19 There may be other questions for which you would not want to look at Column 4.

20 Q I have put my case on that. I think we will move on. We know from your other table that
21 you also produced that the LRIC for a service is in general substantially below its FAC.

22 A I am sorry, you are talking about the fixed common costs note?

23 Q Yes, the fixed common costs table. LRIC ----

24 THE PRESIDENT: Where is this one that you are looking at?

25 MR. PICKFORD: It is the one at Tab 37. There is ordinarily a substantial gap between FAC and
26 LRIC?

27 A It depends what you mean by "substantial" but, yes, there is a gap. There was some
28 information I was taken to yesterday where actually there was not such a gap, but in general
29 there is a gap and it is often relatively material. I think it depends what you mean by
30 "substantial".

31 Q If we could look at BT8 17, which is the RFS again. You have probably put it away. It is
32 AD2, I think. If we look at p.40, just a quick scan, we can see that FAC is in general to be,
33 not always but in certainly the first couple, is about twice and it varies but there is normally
34 a ----

1 A It varies and there is a significantly smaller gap for the higher bandwidth of WES -- No, it is
2 not higher bandwidth. It is just the services listed in the second part of that table, but there
3 is a substantial gap for the services in the first part of the table. So it varies by service
4 according to this information.

5 Q In order to invest in Ethernet services overall, BT needs to know that it is going to cover its
6 incremental investment cost with its incremental revenue, does it not?

7 A That is the minimum, yes. I think there are some reasons why it might need to actually
8 recover more than the incremental cost. This was a relatively new set of services and this
9 set of services, there was significant migration from existing services, from the traditional
10 interface services, from the PPC based services, to these Ethernet services. So what that
11 means is, by offering these Ethernet services BT was losing sales of the traditional interface,
12 the PPC services, and so it was losing the common cost contribution on those services. So
13 even if one is just thinking about the incremental profitability of the investor in Ethernet,
14 where there is this migration going on, that means that BT would require more than just the
15 incremental cost. It would require, in addition, to be incrementally profitable, also the lost
16 common cost contribution on the PPC services that were migrated away from.

17 Q There are essentially two considerations. One is covering incremental investments and the
18 other is ensuring that overall it recovers all of its common costs across all of the relevant
19 services?

20 A No, I am introducing a third consideration. I think you were putting to me that on an
21 incremental basis, if one purely thinks about the incremental investment, BT would just
22 need a return on the incremental costs, and I am saying that that is not correct, that BT will
23 actually need more than that because it would be losing common cost contribution where
24 there was migration. BT would need to recover its common costs overall, I agree.

25 Q If we could go onto the issue of new services, so this is the second part of looking at BT's
26 incentives in relation to dynamic efficiency, in the joint statement, if you go back CB-D,
27 you do not actually address that issue.

28 A Yes, I did not address that in my witness statement, as I recall. I am sorry, could you take
29 me to the ----

30 Q Yes. It is Issue 7.

31 A Yes, I have that.

32 Q So if we could then move on, please, to the issue of downstream competition and
33 downstream investment, that is Issue 8 over the page. Putting aside the issue of consumer
34 outcomes for the moment, because there are a number of considerations that feed into that

1 so I am going to again try to do it step by step, and just starting with downstream
2 competition and downstream investment. You agree, do you not, that a DSAC only test will
3 reduce downstream competition relative to one with an aggregate FAC element as proposed
4 by Sky and TalkTalk?

5 A Yes, that is right. Just it is understood that "downstream competition" here means the
6 access based competition and, yes, I said that in my witness statement.

7 Q It is also going to tend to reduce investment by those CPs because it reduces the returns that
8 they are able to earn from making such investments?

9 A Yes, I guess it would have that effect to some degree. I am sorry, what I was just thinking
10 was it may partly depend on what BT does but if we assume that BT also passes through
11 those wholesale charges then, even in that circumstance, the overall level of prices would be
12 higher in the downstream market and, to the extent there is a consumer response to that,
13 high prices generally tend to lead to less services being purchased, then that would have that
14 effect.

15 Q So either way, if the retail prices went up there is the effect you have just described, and if
16 BT kept its prices the same then obviously the margin that is available for the CPs would be
17 squeezed. I am not saying in a technical sense but it would be compressed.

18 A I see, might be reduced. So, yes, with the quite important caveat that there was a margin
19 squeeze by BT going on, then there may well be -- I would expect there would be -- powers
20 to be able to address that, but if you are making just the point that it may reduce the margin
21 CPs will earn without that constituting a margin squeeze, without necessarily turning those
22 negative, shall we say, yes, I can see that may well happen.

23 Q That would tend to reduce innovation by those CPs?

24 A It tends to reduce their incentive to invest and innovate. Obviously how material that is
25 depends on how much scope there is for innovation in that part of the value chain, but that
26 effect would be present to some degree.

27 Q I would like then to look at upstream entry, so this is Issue 9, and to some extent we covered
28 a lot of this territory already when we looked at the 2004 Statement.

29 A Yes.

30 Q Because we know, for a start, that there are substantial structural barriers to entry, do we
31 not? We agreed on that.

32 A Yes, that is set out in the SMP assessment.

33 Q So any entrant faces the risk that it makes difficult sunk investments and then BT, which
34 can exploit its substantial economies of scale and scope, can just drop its prices after the

1 entrant has entered?

2 A So that is a possibility. One of the points here is there is quite a wide range of possibilities.
3 I think an entrant thinking about the proper entry would need to take into account that
4 possible risk, but also what it would take into account is would BT have an incentive to do
5 that; would it want to do that? If BT drops its price substantially in response to entry it is
6 tending to reduce its own short run profitability. There are economic models which show
7 that under certain assumptions and certain conditions doing that might be overall profitable
8 for BT, I mean, essentially through anti-competitive behaviour, for restricting future entry
9 or entering other markets and therefore earning greater longer term profitability. But it is by
10 no means an inevitability, I think is the point that I am making, that BT would necessarily
11 drop that price down to a low level in response to entry. It is one of a range of possibilities
12 and BT would want to think about the extent to which that was profitable for BT. There is
13 one further point that I think is quite material in this context, which is the nature of the entry
14 that we are talking about. As I described earlier in terms of the vertically integrated type of
15 competitor, primarily that is a CP that is self-supplying in the wholesale market and that is
16 the nature of its entry, is it is self-supplying its services rather than buying them from BT.
17 There may be the possibility of a CP also selling to other CPs, but, as I understand it, that is
18 not the main form of entry that is likely. So if that is what was the entry in play, then that
19 does seem to me relevant to the question of how you might expect BT to respond to that.
20 That is not perhaps as full-frontal a competitive threat to BT in the short term at least,
21 because that CP is not threatening BT's sales to other CPs. It is just threatening the self-
22 supply of the wholesales that BT had to that particular CP. I am sorry, I do not know if I
23 was clear on that point. Let's say that Cable & Wireless, for instance, Virgin actually may
24 be a better example. My point is, if Virgin chose to enter this market or expand its position
25 in this market from self-supplying itself, BT would lose its wholesale sales to Virgin but if
26 Virgin is not engaging in merchant sales to other CPs then BT's sales to other CPs at the
27 wholesale level is not under at least immediate threat. There might be some longer term
28 considerations. So it seems to me that it is relevant when one is thinking about how BT
29 might respond to that entry. It might, for example, respond less aggressively and if it cuts
30 its prices to all CPs then it is reducing its profitability on sales which are not, for example,
31 directly or in the short term under threat.

32 THE PRESIDENT: So it is not really a full competitive entry in the normal sense?

33 A That is right. It might ----

34 Q It is removal of a customer really?

1 A That is it, it is a loss of a customer. It might in due course lead to a longer term competitive
2 threat. A CP that initially started to engage in self-supply might establish a position in an
3 infrastructure at the wholesale level, and it might then be in a position that it would want to
4 then expand or offer some of its capacity to other CPs, which would be, as you put it, the
5 more normal form of competition and competitive threat. But these considerations might
6 play out over quite a number of years as well and it might be across the period covered by
7 more than one Market Review. So there is quite a range of possibilities of what the
8 response to entry might be and also, of course, what the CP might expect the response to its
9 entry to be.

10 MR. PICKFORD: That is a very full answer. I think in order to get through you will have to
11 bear with me a little and try to focus specifically on questions that I am asking.

12 A I will, but that seemed to me extremely relevant to the issue.

13 THE PRESIDENT: I think that was answering your question.

14 MR. PICKFORD: Yes, I understand and I was not criticising that answer per se, but I am just
15 conscious of the time and I have to try to keep the tempo going. Let us assume that there is
16 a firm relationship between pre-entry prices and post-entry prices. So contrary to the
17 proposition that I have advanced before. We are assuming that post-entry prices are closely
18 related, so that pre-entry gives a good signal of post-entry.

19 A Right.

20 Q BT's profits will be reduced in the long run by entry that leads to it losing customers - your
21 type of entry that you are talking about, or entry that actually leads to substantial
22 competition against it, will it not?

23 A Sorry, is your proposition that BT's profitability is likely to be negatively affected by entry?

24 Q That is correct.

25 A Yes, I would agree in general that is the case.

26 Q So BT rationally would tend to set its prices so they are not so high as to encourage
27 substantial upstream entry?

28 A That does not logically follow as the only possibility, or perhaps even the most likely
29 possibility. I address this point in my witness statement. I am just looking for the relevant
30 paragraphs. Yes, this is tab 13 of core bundle D and I am looking at p.43 paras.107 and
31 108.

32 Q I am grateful.

33 A So the point I am making there is again for BT there is a short run/long run trade-off. If it
34 reduces its price in the hope or expectation of reducing entry, it's reducing its short-term

1 profitability. So it would have to judge whether the potential gain it would expect to get in
2 terms of longer term profitability would be sufficient to outweigh that. The point I'm
3 making in paras.107 and 108 is if we are talking about the relative merits of the two tests
4 (which I believe is the issue under consideration) then the relevant question is where there is
5 a price between FAC and DSAC that would be more profitable for BT but which also
6 implied a greater likelihood of entry, and because of this short run/long run trade-off it
7 seems to me that that is plausible that that is the case. In other words, that BT might choose
8 to set a price which does in fact somewhat increase the likelihood of entry compared to
9 pricing at FAC. Sorry, that's the point, that it may choose to do that, based on its profit
10 maximisation choices.

11 Q Thank you. Could we look please at the facts and establish what kind of entry did occur
12 post-2004. I am very happy to take you to it, but do you recall that in the 2008 market
13 review we saw that there was entry by new entrants into the high bandwidth AISBO market
14 where by 2008 they had taken 17% to 18% of that market?

15 A Sorry, I don't recall the exact numbers, but I do recall there had been entry into the high
16 bandwidth, yes.

17 Q If you will assume for me that I am correct about 17% to 18% and we will carry out the
18 questions on that basis. If you could take up, please, bundle BT8 tab 17 again, we are going
19 back to the RFS pp.40 and 41. Looking down the various services here, high bandwidth is
20 above 1 Gbit, is it not, so that falls into the other bandwidth category?

21 A It is above 1 Gbit. I don't see the definition of "other".

22 Q Other is what we see. If you have got 10, 100 and 1,000 and then we have got "others", so
23 by process of elimination --

24 A It suggests that that is above 1 Gbit, yes.

25 MR. READ: I was going to say, sir, that if you look at the Determination you see that they
26 compose another group of 155, I think, and 625. One can see from the Determination itself.

27 A Is there a definition of "other" anywhere in the RFS?

28 MR. READ: I have made the point.

29 A I think perhaps taking that into account, I'm not sure what is in "other" and whether it is
30 only the high bandwidth.

31 MR. PICKFORD: It is at least high bandwidth, but it will cover other things as well. So "other"
32 by definition is the high bandwidth plus various other things too.

33 THE PRESIDENT: It is high bandwidth and some low bandwidth.

34 MR. PICKFORD: Yes.

1 A So yes, OK.

2 Q So if we look at the various figures for "other" we know that in so far as it gives us some
3 sense of scale it will be greater than the figures for high bandwidth because the high
4 bandwidth is going to be subset of other bandwidth. Do you understand that?

5 A I don't think I did quite follow that, no.

6 Q We see here "other bandwidths", OK? We have set out explicitly ten Mbits, 100 Mbits and
7 1,000 Mbits. So everything else must come within "other". We are agreed on that; that is
8 very straightforward.

9 A Right.

10 Q OK. That "other" includes necessarily, firstly high bandwidth and then some other low
11 bandwidth.

12 A OK, yes. I don't know if there's anything else that could be in there, but yes, that
13 presumably includes at least those things.

14 Q At least those things and potentially others. If we then look at the turnover for "other" we
15 see the figure 1 for internal wholesale extension services, do you see that?

16 A Yes.

17 Q Then there is a 4 underneath, so we are up to 5?

18 A Yes.

19 Q Then down the bottom of the page we see another 1 and a 1, so on this page we have got a
20 total of £7 million of revenue attributable to this "other" category?

21 A Right.

22 Q Do you see that?

23 A I see that, yes.

24 Q We see on the next page that the "other" category accounts for £5 million. Do you see that?

25 A Yes.

26 Q So that adds up in total to £12 million.

27 A Right.

28 Q So for backhaul extension services other bandwidth (p.41) is a further £5 million?

29 THE PRESIDENT: I see, the BES and the WES, yes.

30 MR. PICKFORD: Yes. So if we take all of the "other" and add it all together, we get up to £ 12
31 million. You see that?

32 A Yes.

33 Q That has obviously got to be an upper band on the revenue attributable to high bandwidth
34 because we agreed that includes high bandwidth and some other things?

1 A Yes, I guess so. Obviously, that's in this particular year, but yes I would agree.

2 Q We know that BT accounts for about 50% of the high bandwidth market. Do you recall
3 that? We can go to it if you would like me to.

4 A I don't recall that. I'm willing to accept your point, at least as an assumption.

5 Q Let us do it as an assumption for speed. Obviously, I have to take the gambit that if I am
6 wrong about those assumptions, then obviously the point does not work. On the assumption
7 that BT accounts for 50% of the high bandwidth market, an outer bound on the value of the
8 whole market in this year would be 24 million. We have looked at BT's revenues and they
9 are £12 million for high bandwidth and other things. If BT is 50% of the market then the
10 whole market would not be more than about £24 million, roughly?

11 A Again, I am slightly struggling to follow the numbers, but again I'm willing to accept that
12 assumption.

13 Q If the total market is an outer bound of £24 million and entrants (as I said at the beginning)
14 are accounting for approximately 17% to 18% of that market, that means that the new
15 entrants are accounting for a little over £4 million worth of revenue in 2008?

16 A Again, I am taking your numbers.

17 Q Just assume that my calculations are correct.

18 A Yes.

19 Q Looking at these figures, we see that total AISBO revenues at the top of p.40 on turnover
20 note 1 of £439 million, do you see that?

21 A Yes, I see that.

22 Q If you can take it from me that BT has approximately three-quarters of the total AISBO
23 market by value --

24 A You mean the internal sales are about 3, is that what you mean? Oh, BT's market share at
25 the wholesale level?

26 Q Yes, BT's share is about 75% of the whole market.

27 A I see, sorry. So this is BT's turnover, and BT's market share is about 75%.

28 Q That is correct. So we could scale up, and again it is very rough numbers, £439 million to
29 an approximate value for the whole AISBO market of about £600 million?

30 A Again, on those assumptions that sounds a reasonable figure.

31 Q So comparing that to an outer band on the part that is likely to constitute the high bandwidth
32 portion of the market, we see that new entry is likely to constitute about two-thirds of a
33 percentage point of the entire AISBO market.

34 A Again, yes those calculation may well be correct. But, in terms of the implication I think

1 you have to be extremely careful. My view is that this trade-off between different types of
2 dynamic efficiency was made in 2004 based on a regulatory judgement of different types of
3 effects on competition. What you're taking me to here, all this factual information here, is
4 what actually happened. From the point of view of regulatory certainty, when Ofcom
5 makes a decision based on a forward looking analysis (which is the Market Review), that is
6 inevitably going to run the risk of regulatory failure. Ofcom may make assumptions or set
7 out expectations that turn out not to be correct. But nevertheless, for the period covered by
8 that market review until the next market review, it's quite important for reasons of
9 regulatory certainty that there is integrity to the nature of the regulation that's put in place.
10 What this information, if it's correct, seems to be suggesting is that Ofcom was very over-
11 optimistic about the nature of entry that might actually occur.

12 Q Can I suggest to you that it was not over-optimistic at all because we saw what Ofcom said
13 about entry, and it did not think there was going to be any substantial entry.

14 A What it said was "wide scale entry was likely to be limited", or something like that. That is
15 not the same as saying there is going to be no entry. That is the SMP assessment. We saw
16 that in para.7.63 of the 2004 Statement, which set out why Ofcom decided a price control
17 was not necessary. In my view, and my interpretation, it talks about allowing the nature of
18 the development of competition to play out without restrictions imposing a price control.
19 So that was the regulatory judgment made at that time. That may or may not have been
20 correct.

21 Q If we can move on to ---

22 A With the benefit of hindsight, that may or may not have been correct.

23 Q Thank you. If we can move onto a new topic. You believe that your DSAC test should not
24 be applied mechanistically. We can agree on that?

25 A Yes.

26 Q That is a good start. You contemplate a whole range of nuances in terms that would
27 potentially allow BT to avoid a finding of breach, for example, if it is small or limited in
28 duration. Those are factors that you have considered?

29 A There is a range of considerations, yes.

30 Q Indeed you also considered the extent of the excess over FAC. That was another one?

31 A Yes, that is taken into account as a cross-check.

32 Q The precise means by which those nuances will or will not lead to a change in Ofcom's
33 decision as to whether to find overcharging or not, it is very hard to spell out in advance, is
34 it not, in very precise terms because it requires some regulatory judgment?

1 A Yes, one can identify the kind of categories of consideration and one may be able to flesh
2 some of those out, but I agree, it is very difficult to set all of those things out precisely in
3 advance and particularly, as you say, where you may be weighing up different
4 considerations. That is going to be a nature of judgment on the facts available.

5 Q That means BT cannot have it both ways, does it not? It means if it wants absolute certainty
6 it needs a very hard-edged rule, and if it wants greater flexibility with some degree of
7 discretion being exercised by Ofcom, it has to take the rough with the smooth and know that
8 that leads to some greater degree of unpredictability?

9 A I am sorry? When you say "unpredictability" you mean simply that BT may set a price
10 above DSAC or may set a price which it forecasts is not going to be above DSAC but turns
11 out to be, it takes the risk that that may be found to be overcharging if it cannot convince
12 Ofcom that it did have that forecast or whatever. Is that the kind of thing you are referring
13 to?

14 Q Yes. My point is actually just a more general one, that if you want absolute certainty, say
15 BT wants to say, "I can say 100% in the future I know this price will definitely satisfy or
16 definitely will not", then you need a very hard-edged rule, and if it wants greater nuances to
17 be taken into account it has to accept that the trade-off of that is that it becomes less
18 predictable to it exactly how that judgment is going to be exercised.

19 A I think I understand your point better now, yes. As a general proposition at high level,
20 indeed, yes.

21 Q Of course BT has a major advantage in all of this in that under Condition HH3.1 it is BT
22 that gets to decide in the first place how it is going to attempt to satisfy the condition, and it
23 is only if it fails in that exercise that then Ofcom has to step in and effectively do BT's job
24 for it, because BT did not do it?

25 A I certainly agree with the first bit of that. Whether Ofcom stepping in is doing BT's job for
26 it I am not sure, but, yes, I agree that in the first instance BT has the opportunity to justify
27 and to demonstrate how the charges it has set are compliant with the cost orientation.

28 Q Also BT can always seek guidance from Ofcom if it wanted additional help in advance?

29 A Yes, there is that possibility.

30 Q You are also aware that, just as for Ofcom's non-mechanistic application of DSAC, on Sky
31 and TalkTalk's test their approach does not need to be applied mechanistically either?

32 A Yes, I understand that is the suggestion.

33 Q So, for example, if there were a problem with estimation or measurement errors, that could
34 be allowed for under the general approach that is being advanced by Sky and TalkTalk.

1 A So are we talking here about the, excuse me, I think it is the second escape clause that has
2 been listed? Do you mean specifically in relation to FAC, whether or not BT's prices turn
3 out to be above FAC there might be justifications for it?

4 Q Exactly.

5 A And that is analogous to Ofcom's considerations when applying the DSAC test non-
6 mechanistically?

7 Q That is correct.

8 A That is the point, is it?

9 Q Yes.

10 A Yes, I agree with that.

11 Q One of the things about an *ex-post* test as compared to a price control, an *ex-ante* test, is that
12 you actually have the relevant data to be able to assess the test when you are judging it after
13 the event, because BT has produced its RFS whereas, for a price control, you are obviously
14 estimating what costs will be into the future.

15 THE PRESIDENT: I am sorry, when you say an "*ex-post*" test?

16 MR. PICKFORD: Yes, I am suggesting that the cost orientation test is *ex-post* in the sense that it
17 relies on outturn costs. So you evaluate whether BT has passed the test after the event by
18 seeing whether, in fact, its prices match whatever cost test you are applying, as opposed to a
19 price control where you say in advance, "You cannot price above £100" and so BT knows
20 from the very beginning that if it prices above £100 it has breached the test. That is the
21 distinction I am drawing between *ex-post* and *ex-ante*.

22 THE PRESIDENT: Yes, I see.

23 A I think your question was you would have the advantage of having more cost information
24 because you would have the RFS?

25 MR. PICKFORD: Yes.

26 A So that would be the case, but that does not necessarily mean that it is always advantageous
27 to put oneself in that *ex-post*, as it has been described, that situation because it may be
28 extremely hard to evaluate some of the issues. I may be reading too much into your
29 question. I apologise if I am.

30 Q I think you are. Mine is a simpler question. It is ----

31 A So if the question is simply, would ----

32 Q -- in terms of BT's compliance.

33 A So I agree that you would have the RFS, which if you set a price cap on a forward looking
34 basis it would not be relevant, that does not feed into the level of the way in which the price

1 cap is set. What the implications of that are will vary depending on what particular issue we
2 are describing and in some cases that may be an advantage. In other cases I think that
3 would actually be a disadvantage. But if you do not want me to elaborate on implications
4 then ----

5 Q Maybe I could put it this way and we will try and just break it down bit by bit. The main
6 disadvantage of what I called the "*ex-post* control", but the control based on outturn costs, is
7 the problems for productive efficiency, is it not, because it does not give particularly strong
8 incentives for the regulated company to try and beat a target because there is no particular
9 target that it knows in advance that it can beat?

10 A That is one example but I do not know if we are talking about this test in general. In general
11 I think the implications are far wider than that.

12 Q I am just comparing tests based on outturn costs, like cost orientation, as opposed to tests
13 based on estimates of costs, that is price control.

14 A But as you pointed out before, one of your earlier questions, there is a trade-off between
15 greater regulatory certainty or precision in terms of what would be permitted, which you
16 have in what I think we are calling the *ex-ante* approach, compared to you reduce that
17 somewhat in the *ex-post* approach. So given that BT and others know exactly what path the
18 average prices are going to follow under a price cap, in general that is also desirable for
19 investment decisions, for example, and that may be important in particular cases.

20 Q Let us suppose that BT is intending to hit its cost orientation targets on an annual basis,
21 whatever the standard, so we are abstracting away from standard, which means it is
22 intending to hit them year by year. Okay?

23 THE PRESIDENT: By "hit" do you mean price at the ceiling?

24 MR. PICKFORD: Price at or below, yes.

25 THE PRESIDENT: At or below?

26 MR. PICKFORD: Yes. I am sorry, when I say "hit" -- thank you for picking me up -- that is
27 slightly imprecise use of language on my part. That it is intending to ensure that it complies
28 with its obligation, but obviously in a way that is profit maximising, so it wants to get close
29 to what it is permitted to do without over-shooting.

30 A Just to clarify, you are asking me to make that assumption?

31 Q I am asking you to make that assumption, yes.

32 A Okay.

33 Q If BT discovers, say, four or five months into the year that it is over-recovering relative to
34 its expectation of the cost standard that it is trying to set its prices by, it can always

1 compensate for that by dropping its prices for the next seven or eight months with a view to
2 ensuring that, looking at the year as a whole, it still complies with the obligation judged on
3 an annual basis.

4 A That would be the case if it had the cost data contemporaneously which, certainly in terms
5 of the RFS, it would not do.

6 Q No, but it has its management accounts.

7 A Well, its management accounts certainly are not prepared on a DSAC basis. I do not know
8 if I am recalling this correctly, I understood they were not prepared on an FAC basis either.
9 That was in the evidence. I cannot recall if I have got that exactly right. So the answer to
10 your question is, it depends on what cost information BT would have contemporaneously
11 with the year in question.

12 THE PRESIDENT: Does it not also have to give 90 days' notice?

13 A That would also be relevant, yes, in terms of the speed with which BT could react, unless it
14 was permitted a waiver. But, yes, the standard notice period would be 90 days.

15 MR. PICKFORD: Obviously in the situation that I am considering, where it is in risk of over-
16 shooting and therefore in risk of breaching, in order to drop its prices it may well be able to
17 persuade those to whom it is dropping its prices to give it a waiver?

18 Q It may be able to persuade them but my recollection of the particular case that is described
19 in, I think it is covered the Determination and other documents, where BT asked for a
20 waiver, there was an objection from a wholesale competitor. So just because the waiver
21 would be for price reduction does not mean that there could not be objections to it.

22 Q I would like to change the assumption slightly and ask a related but different question. Let
23 us assume that BT think that the worst thing that is likely to happen to it, if it breaches a
24 cost orientation obligation, is that Ofcom comes along afterwards and puts it back into the
25 position it should have been in had it complied. Okay? So that is the working assumption.
26 On that basis, whatever price standard you set, whether it is FAC or DSAC or indeed any
27 other standard, BT in fact has a profit maximising rational incentive to slightly exceed the
28 cost standard so that, to the extent that it under-shoots, it is not losing out because it has not
29 given away profit that it could have taken. And to the extent that it over-shoots a bit, the
30 worst that is going to happen is it will simply be brought back to the price that it should
31 have charged in any event.

32 A So if the tests were applied mechanistically, I think it is very important to say that, then I
33 agree and I agree with the point that you are making that BT may have a profit incentive.
34 There may be other considerations as well that BT would take into account. It may have

1 another profit maximising incentive to behave roughly in the way you are suggesting, and
2 that is essentially covered in my witness statement, in my response to Dr. Maldoom on
3 incentive effects. However, my primary response to Dr. Maldoom on that point is that the
4 test is not applied mechanistically and therefore it is not clear that that effect would actually
5 be relevant in practice.

6 Q If we could look at the issue of causation, and perhaps the best way to deal with it is if we
7 go to your witness statement at Tab 13 of Core Bundle D, and turn to para.123 and 124.

8 A Yes.

9 Q Can you remind yourself of the point that you are making there. Then you go on to deal
10 with the structure of the prices for a few paragraphs at 125 through to 127. I do not need to
11 take you to that. In para.128 you then pick up towards the bottom this issue of causation,
12 and by 'causation' I mean whether prices above FAC in relation to particular services
13 actually causes over-recovery, and you say at the end:

14 "In particular, it would not be legitimate to infer that any sub-set of those services,
15 such as WES/BES services was responsible on its own for any cost over recovery
16 (given that WES/BES prices at DSAC are expected to pass the lower combinatorial
17 SAC tests for AISBO services)."

18 A I'm sorry, where are you reading from?

19 Q I am reading the final two sentences of your para.128.

20 A Thank you.

21 Q I do apologise, because of the time I am trying to compress things a little bit.

22 A Yes, I see it.

23 Q You say:

24 "So, whilst in this scenario ..."

25 and the scenario you have been considering is what we have been discussing, it is pricing at
26 DSAC. You are saying that pricing of DSAC does not necessarily - you cannot deduce
27 from that that prices of DSAC is what has caused the over-recovery. That is the point you
28 are making?

29 A Not solely caused the over-recovery, it may have contributed to it.

30 Q That arises because there is no uniquely correct way of allocating common costs. That is by
31 its very nature, because we have costs that are in common?

32 A Yes, that's right.

33 Q On the basis of that logic, the only pricing limit above which we could actually attribute
34 causation would be if prices actually exceeded SAC. If prices exceeded SAC then we

1 would know that the extent to which they exceeded SAC, that had actually caused the over-
2 recovery. Anything below that, we cannot actually on this very technical view say what the
3 cause was?

4 A Yes, that's a feature of the implication of the theory of contestable markets and the
5 combinatorial tests.

6 Q Again, on this very theoretical approach, the DSAC test suffers from the same problem as
7 you say applies in relation to the FAC test, does it not, because we cannot prove on the basis
8 of a theoretical view of causation that a price that is above DSAC but is below SAC is
9 causing any over-recovery of common costs?

10 A Sorry, I think the point you're making is that prices at DSAC could - or an aspect of the
11 point you're making is that prices could actually satisfy combinatorial tests, for example,
12 which I think is a well-established point that was discussed extensively in the PPC case.

13 Q And prices above DSAC?

14 A Prices above DSAC could potentially satisfy combinatorial tests. So, yes, that is true, that is
15 a possibility. I think, as I have said before, DSAC is a pragmatic alternative to the difficulty
16 of practically implementing this combinatorial test approach.

17 Q I would like to turn back to 124 and in particular where you say:

18 "where there are significant common costs, such as duct, the efficient level of
19 prices is in essence about the overall level of all of the firm's prices, because it
20 relates to the firm's aggregate revenues compared to aggregate costs."

21 Do you see that?

22 A Yes, I see that.

23 Q When Ofcom sets price controls, we agreed before that they are typically set on the basis of
24 FAC - CCA FAC?

25 A Yes.

26 Q Setting charge controls or price controls based on CCA FAC only makes sense in the
27 context of what you say at para.124 if you are implicitly assuming that all other charges
28 which share significant common costs are also in aggregate going to be at FAC?

29 A I think I agree with you that when Ofcom considers that a price control is appropriate, it
30 goes well beyond the considerations set out in this paragraph. It goes back to, I think, what
31 I was saying earlier about the risks of regulatory failure and the balance between market
32 failure and regulatory failure. So where the market failure is sufficiently large, and a price
33 control is considered appropriate despite the risks of potentially being more restrictive than
34 might be allowed, or might be permitted with a contestable market, for example, that's

1 considered appropriate. That's again a regulatory judgment balancing up these different
2 considerations. That's a very intrusive and restrictive approach that Ofcom is taking when
3 it's setting a price control, and so it has to be justified by the circumstances in the
4 knowledge of the risks of regulatory failure.

5 Q One of the concerns of a price control is the overall level of cost recovery, obviously,
6 otherwise you would not be ----

7 A Absolutely, no.

8 Q -- otherwise you would not be imposing CCA FAC.

9 A So the price control is intended to be a tight restriction on cost recovery and prices in cost
10 recovery in our cost of set of services on which it was imposed, absolutely.

11 Q Given that, and given that what you say at para.124 is that the efficient level of prices is, in
12 essence, all about the overall level of all the firm's prices, I would like to put to you a
13 proposition as follows: I suggest that it does not make any logical sense to say in relation to
14 market A, which is where we are imposing a price control, we are going to use FAC in
15 order to try to achieve the appropriate level of prices with regard to the recovery of costs,
16 and at the same time say over here in market B, where it shares significant common costs
17 with market A, we are not going to worry about aggregate over-recovery of common costs
18 and so we do not need a FAC benchmark. Effectively, given what you say in para.124, you
19 are undoing all of your good work in market A potentially?

20 A I don't think you're undoing the good work. When you set a price control on a set of
21 services you're trying to restrict prices and costs recovery on that set of services. So I don't
22 see anything illogical or inconsistent between the two approaches. What they reflect is
23 extremely different, or different, market circumstances, they reflect regulatory judgments in
24 the context of the extent of market and regulatory failure which differs between those
25 different market circumstances, and the trade-off will balance between the different types of
26 economic efficiency. So in different circumstances, very different regulatory judgments are
27 made about the appropriate tight restriction on prices. It's an intrusive approach to impose a
28 price control, but in appropriate circumstances it's justified to impose such a tight
29 restriction. That approach is not justified, in my view, in other circumstances, other SMP
30 circumstances. There are circumstances where BT may have, or BT does have, SMP where
31 it is not appropriate on balance, taking account of the relevant regulatory judgment to
32 impose a price control, and we are dealing with a set of services on which Ofcom reached
33 that very conclusion in 2004, the Ethernet services where Ofcom decided it was not
34 necessary to impose a price control.

1 Q It is correct, is it not, that if CCA FAC is applied consistently over the time to Openreach's
2 regulated services, charges based on underlying efficient CCA FAC should prevent
3 excessive charging and also ensure that delivery of the regulated services is sustainable by
4 allowing Openreach an opportunity to recover all of its relevant efficiently incurred costs?

5 A Again, I think it does go back to market circumstances, but in the market circumstances
6 where the market is sufficiently mature and BT has persistent market power, which are the
7 typical circumstances where Ofcom would impose a price control, then it is the case that
8 that is within the set of prices that does allow for a reasonable recovery and reasonable
9 investment incentives. That doesn't mean that that's appropriate approach in all
10 circumstances, or even in all SMP circumstances.

11 Q Could I ask you turn, please, to ST1, volume 7, and take up tab 29, and go, please, to
12 para.3.15. Do you have that?

13 A Yes.

14 Q That was the proposition word for word that I put to you?

15 A This is in the context of cost basis for new charge controls, and I would expect that to be
16 applying to charge controls. I don't have any objection to that.

17 Q It says for Openreach's regulated services.

18 A You are reading into that that necessarily implies services that are subject to cost orientation
19 and not a charge control. I don't know that that's necessarily the case. I would obviously
20 need to read the document and certainly this section, but the heading that this is under is
21 "Cost basis for new charge control". So it is clearly discussing cost basis for charge
22 controls, and I would agree with that proposition in the market circumstances it's
23 appropriate for charge controls.

24 Q You told us in para.124 of your statement that the efficient level of prices is about the
25 overall level of all of the firm's prices, because it relates to the firm's aggregate revenues
26 compared to aggregate costs?

27 A Yes, so if one only cares about allocative efficiency then that proposition still stands, but
28 that's not the only thing that Ofcom cares about when it sets charge controls, or indeed
29 regulation. Allocative efficiency is usually a significant consideration, but there are other
30 very important considerations as well. I don't see any inconsistency between these two
31 propositions.

32 Q Sir, I had about ten minutes questions on other topics, but I have finished everything on
33 ground 1. I am in the Tribunal's hands as to whether ----

34 THE PRESIDENT: Other topics being what, the RAV adjustments?

1 MR. PICKFORD: Other topics being RAV and just a couple of questions on the issue of interest,
2 which actually Mr. Myers tangentially deals with, albeit he may not realise that he has dealt
3 with it.

4 THE PRESIDENT: Just a moment. If you can in ten minutes deal with the RAV topic, I do not
5 think you need to ask questions about interest.

6 MR. PICKFORD: I am grateful. Mr. Myers, could we finally turn, please, to AD1, tab 6?
7 A Yes, I have that.

8 Q Could you turn, please, to para.3.27, which deals with the RAV adjustment. I should
9 probably say, and give you the proper context ----

10 THE PRESIDENT: I am sorry, what is the paragraph number?

11 MR. PICKFORD: It is 3.27, but prior to being drawn into that paragraph following, we are
12 looking in tab 6 here at the Fixed Access Market Review. This is in the context of charge
13 controls.

14 A Yes.

15 Q This is not the 2012 statement which has been challenged. You explain the reasons in
16 para.3.28 for making a RAV adjustment in this context. Could you read, please, 3.28?

17 A I will read it, but I think it may be pertinent that you say, "You say". In fact, I didn't have
18 any involvement with this document. Indeed, I haven't had any involvement with the RAV
19 issue. Do you still want me to read the paragraph?

20 Q If you could, please, but there may be a limit in that case to the extent to which you can
21 assist the Tribunal?

22 A It was just paragraph 3.28?

23 Q Yes, please. (Pause to read)

24 A Sorry, it's actually some fairly complicated points that are being made. (Pause) Right, I've
25 read that paragraph.

26 Q To summarise, the essential logic that underpins the approach here is that not making a
27 RAV adjustment allows BT to over-recover its costs.

28 A That seems to be the point being made in the first bullet point.

29 Q That logic is equally true in relation to Ethernet services. Not making a RAV adjustment
30 allows BT to over-recover its costs?

31 A I don't think I'm in a position to say. Sorry, let me just clarify if I can say anything on that.
32 So, as far as I can tell, what it seems to be saying is that these services were regulated before
33 1997 on an HCA basis and in 1997 there is a change to a CCA basis. So the source of what
34 is called here the windfall gain or the over-recovery is the change in cost standard, if you

1 like, from HCA to CCA for the regulation of these services. As far as I'm aware, there was
2 no such change in the case of the Ethernet services. So it doesn't seem to be clear on the
3 face of it that what is set out in this first bullet doesn't seem to apply. Well, OK, so it
4 doesn't apply to the services, whether it applies to the assets I'm not sure.

5 Q It is dealing with the underlying assets including, if you see bullet 2, the ducts.

6 A I think that's actually complicated because it's not a simple proposition; it's actually rather a
7 complicated proposition that I wouldn't be in a position to express a firm view on that
8 without reviewing this and probably significant other documentation on the RAV issue.

9 Q I am very grateful. I have no further questions, thank you.

10 THE PRESIDENT: I think perhaps it is sensible to take a short break now before you start your
11 re-examination. Ms Gallafent, do you know how long?

12 MS GALLAFENT: I know how long my question will be, sir, if that is any assistance.

13 THE PRESIDENT: I see. If it is one question, you go straight ahead then. We will take a break
14 afterwards.

15 MS GALLAFENT: I am very grateful.

16 Re-examined by Ms GALLAFENT

17 Q Mr. Myers, you were asked about para.7.63 in the LLMR which is BT3 p.169.

18 A Yes, I have it.

19 Q You were asked about your views on what that paragraph meant and you indicated that you
20 considered it may also be worth commenting on alternative interpretations that have been
21 advanced in these proceedings. Could you assist the Tribunal, please, by explaining what
22 those alternative interpretations are and what your comments are on them?

23 A My understanding is there are two alternative interpretations compared to mine that have
24 been put forward. One is that Ofcom's reason not to impose a price control in this Market
25 Review was because of the difficulties in forecasting costs that would be necessary to
26 impose a price cap. I think I did actually have the opportunity to comment on that, so I will
27 only briefly reiterate that that does not seem to me to fit with the wording of this paragraph.
28 This paragraph says it is not currently necessary to impose a price control; it doesn't say a
29 price control is appropriate in principle, but it's difficult to forecast costs. Indeed, the fact it
30 is saying it is not necessary seems to me inconsistent with that alternative interpretation.
31 The other interpretation I am aware of is, I believe, the one that Mr. Pickford put forward in
32 opening submissions, which was that in the second sentence, "give time for the effects of
33 the cost orientation obligation to impact on the competitiveness of the market" might be
34 referring to the downstream market, not to the upstream market. That doesn't seem to me to

1 fit very well with this paragraph either, or the logic underlying, because in the first place the
2 price control that's being discussed here is clearly the price control in the wholesale market.
3 So the paragraph is essentially about the wholesale market. Furthermore, it's the
4 competitiveness in the wholesale market that's a much more relevant consideration for a
5 need for a price control alongside other factors such as the maturity of the market rather
6 than competitiveness of the downstream market. So, for example, if the wholesale market
7 had, contrary to what actually happened of course – perhaps I should take the case of high
8 bandwidth. In the case of high bandwidth, in 2008 competition had developed sufficiently
9 such that there wasn't SMP. In other words, it was an effectively competitive market. In
10 that case, there was no price control needed. On the other hand, for the low bandwidth
11 Ethernet services, it was a more mature market, SMP was more established and considered
12 to be more persistent, and in that case, because of the lack of development of competition in
13 the wholesale market it then did become necessary or appropriate to impose the price
14 control.

15 So the logic underlying this seems to me to conflict with the alternative, second alternative
16 interpretation that has been put forward.

17 Q Thank you very much. That was my only question. Thank you, sir.

18 THE PRESIDENT: We will take a 15 minute break now and come back at 25 past.

19 Adjourned for a short time

20 THE PRESIDENT: Mr. Myers, I think you were at the Tribunal when Ofcom's leading counsel
21 opened the case and you may recall that he said that if Ofcom had used FAC as its
22 benchmark for the ceiling for the cost orientation that BT would have had strong grounds
23 for complaint and, indeed, I think he said a successful challenge. You were asked quite a lot
24 of questions by Mr. Pickford, showing you various Ofcom documents to the effect that
25 Ofcom has used FAC in various circumstances. I wonder if you can help us a bit, and it
26 may be that you were not involved personally in all of this but you are the only witness
27 from Ofcom, on what basis Ofcom considers that BT and others should have realised that
28 DSAC is the measure that Ofcom would apply as opposed to FAC?

29 A I think I can at least provide some assistance on that question. On the question of DSAC,
30 the relevance of DSAC to cost orientation, there are the factors considered in the *PPC* case.
31 For example, in BT's regulatory financial statements and the associated documents, they set
32 out, my recollection at least is that they set out -- obviously the RFS publish DSAC and
33 DLRIC data -- and, second of all, my recollection is that those documents, and associated
34 documents, describe the role of DSAC and DLRIC as providing the limits on pricing

1 flexibility under cost orientation or similar words to that effect. So that is one piece of
2 evidence in terms of the relevance of DSAC, as well as obviously there were previous
3 guidelines issued by Oftel in 1997 and 2001 in relation to the network charge controls. I
4 have not emphasised those because I am conscious that the Tribunal in the *PPC* case did
5 not, as I recall, place very much weight on those. But those were other guidelines that
6 referred to DLRIC and DSAC as the, I think in that case and those guidelines, as a first
7 order test for cost orientation. In relation to FAC, I would say that the point I was making
8 in relation to the price control and the decision in 2004 not to impose a price control, is
9 highly relevant to the question of what reasonable expectation would have been about
10 whether a group FAC test would be applied or not. In my view, I think, as I have set out in
11 my witness statement, a FAC test represents a form of price control. It is a cost plus rate of
12 return form of price control as opposed to a price cap, but we know that when Ofcom does
13 set a price control it uses the FAC cost standard as the relevant cost standard for setting
14 those price controls, typically with a glide path to a forecast level of that FAC, but
15 nevertheless a FAC. So it seems to me that the rejection by Ofcom of imposing and the
16 decision not to impose a price control in 2004 means that there would have been a
17 reasonable expectation that a group FAC test, a cost plus rate of return regulation having
18 similarly tight restriction and, in some respects, tighter restriction on prices than a price cap,
19 would have been reasonable to expect that would not be applied once the price control had
20 been rejected.

21 Q Does that apply to the sort of averaging FAC across services?

22 A I am talking about the group FAC test, not the cross-check and the relatively minor role
23 compared to DSAC that it plays in Ofcom's approach, but in relation to the group FAC test.

24 Q But on the price controls is it a group FAC test?

25 A What there is is a basket of services. The price control applied to a basket of services, and
26 what the price control regulates is the average price of the services in that basket. In my
27 witness statement I drew the parallel on that issue between a basket of services for a price
28 control and the considerations that were being put forward by Dr. Houpis in the context of
29 how you construct the group of services to which this group FAC test would apply. So I
30 would say that they are very analogous, those two considerations.

31 Q Just on the first two points you mentioned, you referred to the RFS, which includes DSAC
32 but also includes, of course, FAC. You say it describes the role of -- can you help ----

33 A I do recall this was dealt with at length in the *PPC* case. I cannot recall whether it is on the
34 face of the RFS themselves or within some of the associated accounting documents, such as

1 the DAM or the LRIC methodology relationships and parameters document.

2 Q Then in the guidelines, which go back a bit now, do they not, I think 1997 and 2001 ----

3 A That is correct.

4 Q -- there is nothing more recent, is there, in terms of guidelines?

5 A I do not recall if there has been any further versions of those guidelines but certainly the

6 ones referred to in the *PPC* case were the 1997 and 2001.

7 Q I think the same are referred to in this Determination.

8 A Yes, that may well be, yes.

9 Q Chapter 4. In those, you have not actually been taken to those, I think, but if we look at

10 those, which are in Bundle ST1-3 ----

11 A I am sorry, is it ST1-3?

12 Q Yes, ST1-3. I think the first ones are at Tab 16.

13 A Yes.

14 Q It may be that we need to go to the 2001 because I think some of the figures are a little bit --

15 which is the next tab, Tab 17.

16 A Yes, I have it.

17 Q I think certainly the reference in the statement, in the Determination, is to Annex B, which

18 is at p.26.

19 A Yes.

20 Q Can you help me, is it the part of this that begins on p.31 about combinatorial tests?

21 A No, I think that is actually dealing with -- if you recall, earlier today I drew the distinction

22 between individual services stand-alone cost and combinatorial tests compared to using

23 DSAC as an alternative. It is actually p.26 where it is referring to floors and ceilings and

24 thereafter. Floors and ceilings are referring to DLRIC and DSAC.

25 Q The reason I mentioned the bit on p.31, it is I think, and you will correct me if I

26 misunderstood it, the introduction of DSAC is, is it, B15?

27 A Sorry, I think this goes back to a question I was asked yesterday, I think by Professor

28 Mayer, where I said there's been some change in terminology over time. In this document

29 floors and ceilings mean DLRIC and DSAC. What it's describing when it refers to

30 "'distributed incremental cost floors' and 'distributed stand-alone cost ceilings' " those were

31 terms that were used originally by BT and then they were later adopted more generally. But

32 at the time of this document, Oftel was referring to DLRIC and DSAC as floors and

33 ceilings, and it was the DLRIC and DSAC were terminology used by BT. What this text is

34 effectively describing is that this means floors and ceilings as specified earlier, because the

1 floors and ceilings as specified from the start of Annex B. What they do is they take the
2 whole of conveyance as the increment, so that's a broad increment, broader than individual
3 services or individual components across the whole of conveyance. So you get the stand-
4 alone cost of that broad increment of conveyance and then that's distributed amongst the
5 individual components or services. So that's the distribution to the level of individual
6 services through components. So that's the distributed stand-alone cost. What it's
7 describing in at least the second part of B15 is, if we look – so it's actually contrasting, what
8 B14 and B15 are doing are contrasting what you would get if you applied the individual
9 level tests, here expressed in terms of the components, if you defined each component as a
10 separate increment. That is the contrast being made in B14, for example.

11 "Floors and ceilings for inland conveyance, derived as set out in these guidelines
12 with the increment defined as the whole of conveyance, can be contrasted with the
13 average incremental and stand-alone costs which would result from regarding each
14 network component individually as an increment.."

15 So it's the contrast between those two. Then it later goes on to say that if you were using
16 those individual level component increments or service increments, you would also need to
17 conduct combinatorial tests. That is my recollection. So it is actually these paragraphs that
18 are drawing the contrast between DSAC applying to the increment for the whole of the
19 conveyance compared to an alternate approach which will be closer to the theory of
20 contestability where you define the increment at the level of each individual service or
21 component.

22 Q Then B17. That is to do with this approach, the alternative approach to DSAC, taking
23 individual service increments and then you'd need to also do combinatorial tests. That's in
24 B16:

25 "If components were regarded as increments, floors and ceilings would need to be
26 satisfied not only for each component individually but also for each combination of
27 components where there are common costs between components."

28 So it is saying you would need to do combinatorial tests as well as the individual level
29 incremental and stand-alone costs tests.

30 Q Yes, I see. Thank you. You referred just now to using FAC in a group, a basket of FAC as
31 you do for pricing and you said as opposed to using it as a check which I think you said in
32 the Determination is what Ofcom did in that what is referred to as a non-mechanistic
33 approach to DSAC. How did Ofcom actually use FAC as a check or cross-check?

34 A It was generally used as confirmation of further evidence supporting a conclusion of

1 overcharging from the failure of the DSAC test. I don't know if you want me to elaborate
2 further on that. It would probably be worth turning to the Determination and perhaps
3 looking at a specific service.

4 Q I understand that, confirmation of overcharging through the DSAC test. Was it used in the
5 other situation where, say, price was below DSAC, to see whether nonetheless it was
6 overcharging because it was so much in excess of FAC? Was it a one way cross check, as it
7 were, or when you say it was not used mechanistically do you mean in the sense that price
8 over DSAC was not necessarily regarded as failing the test, but does it also mean that price
9 below DSAC might be regarded exceptionally as violating the condition?

10 A Could I just remind myself by turning to the Determination?

11 Q Yes, that is core bundle B.

12 A The general approach to that issue that Ofcom took is, I think, covered in para.9.184 p.120
13 which describes the cross check approach. Essentially, it is in the nature, or along the lines
14 of I think the one way test you described. Second sentence:

15 "The use of FAC in this manner can act as a useful cross-check to ensure that
16 unjust outcomes are avoided. A charge being above FAC is not in itself sufficient
17 to demonstrate overcharging has occurred. However if a charge was above DSAC,
18 and revenues were significantly above FAC, this evidence would corroborate a
19 conclusion of overcharging."

20 So that is in terms of the general approach. Then in terms of a specific service – actually,
21 the example I just identified probably wasn't a very good example so could you just bear
22 with me and I will try to find a slightly better example. (Pause)

23 An example (I'm not suggesting this is perhaps the best example) in relation to BES 1000
24 rental on p.359 and 360 in 2010/2011, so if we look at the table 14.7 on p.359 in 2010/2011
25 we can see that the external revenue was £3,500 or so, and the FAC was £2,500 whereas the
26 unit DSAC was £4,743. So this is an example of a price that was less than DSAC but above
27 FAC.

28 Then if you turn to the next page, para.14.112 it says:

29 "The parties have not put forward any specific arguments which cause us to
30 consider these charges below DSAC are nevertheless not cost orientated."

31 So that is, as it were, an application of that largely one way test that was described in the
32 general approach, that a price above FAC is not sufficient to constitute overcharging in the
33 absence of further evidence.

34 Q Yes, thank you.

1 PROFESSOR MAYER: Dr. Myers, could we turn to the issue of promoting competition. As you
2 say in your report, there are two ways in which the market might be stimulated. One is
3 through entry and the other through investment and innovation by BT itself. In paras.114,
4 115 and 116 you discuss that issue. Could you just explain whether, and if so why, DSAC
5 can be justified on the basis of promoting investment and innovation as against entry into
6 the market?

7 A Sorry, promoting investment by BT?

8 Q Yes.

9 A Sorry, is this compared to a specific alternative such as FAC?

10 Q Yes.

11 A Apologies for another question of clarification. Is this in general, or on the facts of this
12 specific case?

13 Q I would like to hear about the justification in general?

14 A In general, right. In general, particularly in the case of a new market, the question of 'fair
15 bet' could be quite material, of some relevance, and one of the difficulties with responding
16 to 'fair bet' issues where they arise is that it can be extremely difficult to quantify how one
17 should take account of them. So it is perhaps easier to identify the relevant set of
18 circumstances where such issues may be in play. Just to be clear about what we're talking
19 about, we're talking about the firm, in this case BT, making the investment, for that to be
20 efficient, it should on an expected basis be able to earn the appropriate risk adjusted costs of
21 capital. Looking at the range of possible outcomes, I just simplify that to a successful
22 outcome and an unsuccessful outcome. Clearly, in reality, there was a range of scenarios.
23 In the unsuccessful outcome there may be no prices at which that investment would be
24 profitable, and again, to illustrate the point, let's assume that. That means that if we observe
25 the successful outcome, in order for the expected profitability at the point when investment
26 is made to match the risk adjusted costs of capital, if we're observing a successful outcome,
27 that return would need to be significantly in excess of the cost of capital in order for that
28 expected investment to be correct as regards the right investment signals. So that's the
29 nature of the issue.

30 If one was in a position where the regulator considered that those 'fair bet' considerations
31 were pertinent, as is the case in some other markets in other contexts, then the question is
32 how can we allow for that? One of the problems with FAC - perhaps I should say, first of
33 all, I think one of the fundamental problems relates to a theme I was raising earlier, which is
34 about regulatory failure. It's just extremely difficult to identify how much higher than the

1 risk adjusted costs of capital the return should be in the successful outcome, because one
2 would need to know the distribution of outcomes and the scale of the expected losses in the
3 case of the unsuccessful outcomes. That's a very difficult task and there would be a high
4 risk of getting those calculations wrong. So it's a very substantial problem of regulatory
5 failure.

6 That, I think, is the fundamental problem with applying a tight restriction on prices such as
7 FAC compared to DSAC, because if one could quantify these things one might be able to
8 use it as a FAC kind of test in conjunction with a quantified adjustment to account for 'fair
9 bet', but if one is not in a position to quantify those things on a reliable basis a better
10 response is likely to be allowing more headroom to accommodate the fact that where we
11 observe a successful outcome - because, after all, if we observe an unsuccessful outcome
12 then it's unlikely the prices are excessive. The concern about excessive prices would be
13 more in a successful outcome. So it's in the context of the inability to quantify the scale of
14 'fair bet', I would say that where that's relevant that a DSAC type approach would be better
15 for investment incentives compared to FAC.

16 Q I thought earlier on we had discussed the way in which the 'fair bet' consideration could be
17 taken into consideration and suggested that that might be best done through looking at the
18 cost of capital and an appropriate adjustment to the cost of capital, and that the issues of cost
19 allocation might be rather separate from that question about an appropriate cost allocation,
20 and indeed that Ofcom, in looking at the issue, felt that there really was not a justification in
21 terms of the cost of capital for making an allowance that resulted in a deviation from BT's
22 standard cost of capital?

23 A There's a number of questions there. I hope I'll identify them all in my answer. On that
24 point, that is not how Ofcom looks at it, that the 'fair bet' is simply a question of getting the
25 right cost of capital. As I say, the nature of the issue is that you observe an outcome, and I
26 am not saying a successful outcome, and that you may have identified exactly the right risk
27 adjusted costs of capital, but the fair bet consideration still implies that BT in this case
28 should be permitted to earn in excess of that risk adjusted cost of capital in the successful
29 outcome in order that the return expected before the investment is made, where the
30 unsuccessful outcome is also a significant probability, matches the risk adjusted cost of
31 capital. Before I move on, is that clear?

32 Q Yes, that is clear.

33 A So it's an additional consideration to getting the right weighted average cost of capital. I
34 think, as I have already said, it is very difficult to quantify exactly how one takes account of

1 that. My point about, if you like, cost allocation or the different cost standards, was not
2 actually that that is the correct way to take account of that from the point of view of the
3 underlying logic. It isn't. My point was a much more pragmatic one in the context of
4 serious difficulties in being able to quantify what one should do in the context of 'fair bet'.
5 My point was that if one considers the relative merits of DSAC versus FAC, FAC
6 essentially doesn't allow headroom for 'fair bet' considerations, whereas DSAC potentially
7 can do. Whether it allows the right consideration, I'm not suggesting it does because I've
8 suggested it would be very difficult to identify what that would be. So, if you like, there are
9 less serious consequences for 'fair bet' considerations, if they are relevant, comparing FAC
10 to DSAC. If you look at FAC, that is restricting in the successful outcome BT to exactly its
11 weighted average cost of capital, which means that if there's an unsuccessful outcome on an
12 expected basis it will earn less than its cost of capital. That's what I mean by not allowing
13 headroom, whereas DSAC doesn't have that characteristic.

14 In relation to this specific case, which is why I asked that question of clarification at the
15 start, Ofcom's rationale - perhaps I should say my understanding is, though these are not
16 matters I've been directly involved in, that Ofcom has used that more recently these 'fair bet'
17 considerations and the difficulty of quantifying them as a reason or part of the reasons for
18 not imposing a price control on relatively new markets or new products. However, in this
19 specific case when we look at this para.7.63 in the Leased Line Market Review the
20 justification for not imposing a price control is not about 'fair bet', it doesn't talk about that.
21 It doesn't seem that that was one of the reasons in 2004, and furthermore Mr. Pickford took
22 me to the part of the Determination where, with the benefit of hindsight, Ofcom also
23 assessed that question and concluded on the basis of available evidence that there wasn't a
24 need to make allowance for those things.

25 In general, that could be a relevant consideration and a material consideration in choosing in
26 certain circumstances between a DSAC approach and a FAC approach, but I don't think it's
27 very clear that it's important in this particular case.

28 Q Do you think that it can justify the rates of return that we observed earlier on when we were
29 looking at the ROCEs which, even after the adjustment for overcharging and even taking
30 account for internal transfers within BT, still amounted to, on average, twice BT's normal
31 cost of capital?

32 A Again, on the specific facts of this case?

33 Q Yes.

34 A On the specific facts of this case, as I think I've already said, that wasn't part of the

1 consideration when Ofcom decided not to impose a price control, and Ofcom, on the basis
2 of the evidence, didn't find it was a significant consideration in this case. So I'm not
3 suggesting that is a justification for that rate of return in this case. More generally, I think it
4 actually could easily be - it wouldn't be that surprising that the 'fair bet' consideration could
5 imply that kind of excess over the WACC.

6 Just going back to the stylised case, there's a successful outcome and an unsuccessful
7 outcome, let's say they're equally likely and let's say BT would earn zero rate of return in the
8 unsuccessful case, in that situation, to give the right *ex-ante* actually BT would need to earn
9 twice its cost of capital in order for the 'fair bet' consideration to be taken into account.

10 Q Thank you.

11 MR. HARRISON: Can I take you p.309 of the Determination, it is to do with provisioning costs,
12 which is core bundle B.

13 A Yes.

14 Q When we look at table 13.24, it does look as though provisioning costs were understated in
15 earlier years. Ofcom actually says in the para.13.358 that it looks as though that probably
16 was the case but there was not evidence. Going back to your criteria, for altering the RFSs,
17 it was either an error, an obvious mistake in methodology, but it had to satisfy that there was
18 no knock-on effect, if I can summarise it as simply as that, there was no knock-on effect
19 elsewhere in the RFSs as a result of making the change. What you are saying there is that
20 you did not have the evidence. Mr. Coulson in his final report, his fourth report, which is in
21 the witness bundle, core bundle D, tab 19, actually sets out his evidence for it. At appendix
22 B, we were taken to that by Mr. Saini when he was cross-examining Mr. Coulson, and
23 basically said, "Look, there are a lot of these costs that get allocated elsewhere to items that
24 are controlled from a cost or a price control point of view". Mr. Coulson's response was,
25 "Yes, but in relationship to those individual lines, the copper lines, it is insignificant,
26 materiality wise it is very small". What would your view on that be?

27 A I would find that a very troubling principle, because essentially, if you think of this - the
28 argument, as I understand it, just to make sure I've understood the argument correctly, is
29 whatever it was, however much money it was ----

30 Q The total is £18 ----

31 A £18 million, so £18 million is very small in relation to LLU or WLR, therefore it would not
32 have a significant impact on the unit cost and therefore the unit price that was set. So it
33 would be reasonable therefore to move that cost across to the Ethernet services. If we think
34 of this in £million terms, what that's saying is, whatever the figure was, £18 million, was

1 taken into account in setting the price control for whichever it was, WLR, say. The
2 argument is, despite the fact that it was taken into account in that case, it should
3 nevertheless still be shifted across into Ethernet. That seems to me to be a clear case of BT
4 getting the £18 million twice. If the principle is established that as long as it doesn't have a
5 material impact to however "material" is defined, a material impact on the unit price, one
6 could imagine that there are lots of price control services. We could move small amounts of
7 £million amounts from a series of price controlled services and then, when one adds up that
8 £million amount it could turn out to be quite a significant amount of money. So I find, as I
9 say, the principle troubling. I think it seems more appropriate to me to think of this issue in
10 terms of the £million amounts and being shifted around in effectively being double-counted,
11 being recovered twice.

12 Q Thank you. I think I can anticipate your answer, but if this evidence had come at the time of
13 your provisional Determination, would it have satisfied those three criteria that you had at
14 the time for altering the RFSs?

15 A Sir, I think I need to be slightly cautious in answering that question because this was
16 actually one area of the Determination I did not have responsibility for. It was actually a
17 colleague. So it was a colleague of mine and other colleagues who were actually making
18 those judgments on these cost adjustments in Section 13, but I think I could say that the fact
19 that these costs were already allocated to other price controlled services would be a
20 significant argument against making that cost adjustment.

21 MR. HARRISON: Thank you very much.

22 THE PRESIDENT: Is there anything arising from the questions that the Tribunal has asked?

23 MR. PICKFORD: Yes, I just have one or two questions arising out of Professor Mayer's
24 questions on the issue of fair bet.

25 THE PRESIDENT: Yes.

26 Further cross-examined by Mr. PICKFORD

27 MR. PICKFORD: I will be brief. Mr. Myers, you suggested in relation to a question from
28 Professor Mayer that fair bet considerations were not merely relevant to the rate of return,
29 that they also entered into some sort of more general assessment of BT's prices.

30 A No, I do not think that is quite what I said. I think I said it was not encompassed by getting
31 the right weighted average cost to capital. One could identify the right weighted average
32 cost of capital and still have a fair bet consideration and some of the simple stylised
33 examples I gave I think illustrate that, where, in the case where there was an equal
34 probability of a successful or unsuccessful outcome, in order to take account of fair bet, if

1 that was relevant, with zero return in the unsuccessful case, BT would need to earn twice its
2 weighted average cost of capital in the successful outcome. If one restricted BT's return in
3 the successful outcome just to its WACC, that actually would not actually create a
4 circumstance where there would not be a fair bet where it actually would send a wrong
5 signal for investment decisions.

6 Q So the point you are making is that you can allow something above the WACC if the fair
7 bet considerations are properly justified?

8 A Yes, that is a helpful way to summarise it.

9 Q But in the Decision you assess the fair bet considerations and you ultimately decided they
10 were not justified?

11 A Yes, yes, I agree. I hope I made it clear that I was asked the question in general. In the
12 specific case here, I was not suggesting it was relevant.

13 Q When you are assessing fair bet issues you cannot do so with the benefit of hindsight, can
14 you? To be fair to BT, you have to put yourself in the position that BT was in in 2004 when
15 considering its investments?

16 A Indeed, at least that is the nature of the issue of how the concern arises, is BT's expected
17 return at the point at which it is choosing whether to make the investment.

18 Q So you are putting yourself in that position which is precisely the position that you were in
19 when you, in fact, imposed the 2004 Statement?

20 A Yes. Yes, that is correct.

21 MR. PICKFORD: Thank you. I have no further questions.

22 THE PRESIDENT: Do you have any questions, Mr. Read?

23 Further cross-examined by Mr. READ

24 MR. READ: I deliberately did not ask you about the question of provisioning costs because, as I
25 think you have already fairly said, it is simply not an area that you were directly concerned
26 with in the course of the Determination, which I think we are agreed about.

27 A That is correct, yes.

28 Q There are other instances though, are there not, where effectively costs have been excluded
29 by Ofcom and, in essence, not put back into the other markets elsewhere. So, for example,
30 if we take 21 century costs which got excluded from Ethernet, they do not necessarily go
31 into some other market to balance the equation out, if you like, in that instance? Or perhaps
32 it is something you do not know enough about to really comment on?

33 A I do not have a full picture of that. I understand the essential reason for excluding those
34 costs here, as they are not relevant, because they are relevant to the costs of a different set of

1 services, but the detail of exactly what happened elsewhere and the implications of that I am
2 not aware of that detail.

3 Q You are not able to comment upon?

4 A No, that is correct.

5 MR. READ: I think that is all I need to ask.

6 THE PRESIDENT: Yes, Ms. Gallafent?

7 Further re-examined by Ms. GALLAFENT

8 MS. GALLAFENT: I am grateful. Mr. Myers, you were asked about references in the RFS to
9 DSAC and FAC and DLRIC, and you suggested that they were dealt with at length in the
10 *PPC* decision but could not recall. Can I ask you just to turn up Core Bundle E and turn to
11 Tab 9, where I hope you have the judgment of the Tribunal in the *PPC* case. If you turn on
12 to p.30, para.104 - (after a pause):

13 A Yes.

14 Q Is that the part of the *PPC* judgment that you were referring to?

15 A That is indeed, so perhaps the most pertinent in this context is para.104 (2), the quotation,
16 the second part of that quotation:

17 "Complex combinatorial tests are avoided through the use of DSACs which will
18 reduce pricing freedom by lowering the maximum price that can be charged".

19 That was one of the things I had in mind, yes.

20 Q You were also asked by the President questions in relation to how BT might reasonably
21 have known that DSAC was the cost standard against which their cost orientation would be
22 measured. If I could ask you, please, to turn onto para.278, p.81 in the same Decision?

23 A Yes. Should I read the entire paragraph?

24 Q Perhaps if you can just read from para.278? Do you see 278(1) deals with the Oftel 1997
25 guidelines, to which you referred.

26 A Yes. (After a pause):

27 Q Again in this context, you suggested that this issue was dealt with in the *PPC* decision. Are
28 those the sections that you were referring to?

29 A Yes, they are. I do not know if there are any others but these are certainly relevant to that
30 issue.

31 Q If I could just ask you to turn on to para.286, and in particular 286(2), perhaps you could
32 just read that, Mr. Myers? (After a pause):

33 A Yes.

34 Q Again was that one of the passages you were referring to dealing with difference between

1 DSAC and FAC and BT's reasonable expectations?

2 A Yes, again that is certainly relevant to that question.

3 MS. GALLAFENT: Thank you very much indeed. Thank you, Sir.

4 (The witness withdrew)

5 THE PRESIDENT: Thank you. We will now adjourn until Thursday of next week. If you could
6 please written closings to the Tribunal by 4p.m. on Tuesday, if at all possible, and certainly
7 by the end of Tuesday -- Yes, Ms. Rose?

8 MS. ROSE: Can I make one suggestion, which is that it would be helpful if everybody attempted
9 to make the body of their closing submissions non-confidential and to put any confidential
10 material they need to refer to into an annex, because that would enable us to take
11 instructions on closing submissions. Obviously there is not going to be enough time to
12 produce confidential and non-confidential versions.

13 THE PRESIDENT: Yes, that would be extremely helpful. Even if one has to refer to a figure it
14 can be done by a sort of asterisk.

15 MS. ROSE: Yes, and there could be a confidential annex.

16 THE PRESIDENT: Which can be related to a confidential table.

17 MS. ROSE: Yes, Sir.

18 THE PRESIDENT: Just one moment. (After a pause): Could we please have them electronically
19 sent to ... here at the Tribunal?

20 MR. READ: Sir, just before you rise, BT has prepared two documents which it has taken from
21 the material within the bundles. Primarily it is just a chart showing the various figures from
22 the RFS tables, the first document. It is simply to put it all together in one chart so that
23 people can actually see where it is.

24 THE PRESIDENT: Yes.

25 MR. READ: The other document relates to BT's prices, which again are primarily taken from the
26 Decision itself, where you have those graphs and it shows the various price levels, just to
27 show how BT's prices were actually moving throughout the period. We think they are non-
28 contentious. We will hand them up to the Tribunal this evening and obviously it will give
29 people a chance to have a look at them before their written submissions have to go in.

30 THE PRESIDENT: Yes. When you say "non-contentious" you mean that ----

31 MR. READ: They have not seen them yet. We think they should be non-contentious.

32 THE PRESIDENT: By that you mean "accurate"?

33 MR. READ: Yes, we hope accurate. We certainly hope accurate.

34 THE PRESIDENT: Would it be sensible for you to show them to the other parties first ----

1 MR. READ: By all means, Sir.

2 THE PRESIDENT: -- and then you can supply them on the end of Monday or Tuesday morning.

3 MR. READ: Yes, we can do that.

4 THE PRESIDENT: I think that is probably more satisfactory so everyone has a chance to look at
5 them.

6 MS. ROSE: It would be useful if we could have those electronically.

7 THE PRESIDENT: From Mr. Read?

8 MS. ROSE: Yes.

9 THE PRESIDENT: You can have a word with Mr. Read and I am sure he will seek to satisfy
10 that. I think we kick off on Thursday with Ofcom's closing at 10.30 on Thursday morning.
11 Thank you all for your cooperation which has enabled us to finish exactly at half-past 4.
12 Mr. Myers, I do not think I said formally that you are released!

13 (Adjourned until 10.30am on Thursday, 21st November 2013)

14
