IN THE COMPETITION APPEAL TRIBUNAL Case No: 1381/7/7/21

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

Monday 29th January – Friday 22nd March 2024

Before:
The Honourable Mr Justice Waksman

Eamonn Doran

Derek Ridyard

(Sitting as a Tribunal in England and Wales)

BETWEEN:

Justin Le Patourel **Class Representative**

v

(1) BT Group PLC
(2) British Telecommunications PLC **Respondent**

A P P E A R A N C E S

Ronit Kreisberger KC, Derek Spitz, Michael Armitage, Jack Williams and Matthew Barry (On behalf of Justin Le Patourel)

Daniel Beard KC, Sarah Love, Daisy Mackersie, Natalie Nguyen and Ali Al-Karim (On behalf of BT Group PLC and British Telecommunications PLC)

Jennifer MacLeod (On behalf of the Competition & Markets Authority)

Wednesday, 21 February 2024

(10.30 am)

THE CHAIRMAN: Good morning. Some of you are joining us via the live stream on our website, so I must start with the customary warning: an official recording is being made and an authorised transcript will be produced, but it is strictly prohibited for anyone else to make an unauthorised recording, whether audio or visual, of the proceedings, and breach of that provision is punishable as a contempt of court.

We will continue with the questions that were being posed by Mr Ridyard yesterday.

MR DAVID PARKER (continued)

MR MARTIN DUCKWORTH (continued)

DR HELEN JENKINS (continued)

MR DAVID MATTHEW (continued)

Questions by THE TRIBUNAL (continued)

MR RIDYARD: I would like to ask a few more questions on the topics we were knocking around, exploring, at the end yesterday.

Maybe the easiest place to start would be with the -- I think one of the last things we looked at was the comparison of -- in Mr Duckworth's second report on page 59 where we were looking at this bar chart which was examining BT's EBIT margins with and without SFV services in it. {IR-E/7/59}

I suppose the premise here is that looking at EBIT margins absent SFV is a kind of a benchmark for the competitive level. Is that the rationale for this, or was it less ambitious than that?

MR DUCKWORTH: Just to clarify, this is not removing SFV in totality. What I have done in this chart is look at the estimated overcharge on SFV from my methodology and subtracted that from EBIT, so it is leaving SFV in when adjusting for the overcharge. Clearly the idea is to kind of remove the fact that any excessive pricing in SFV will bias the result.

So the green bars, which only start in 2015/16 because that is when the estimates of the overcharge we have, are an estimate of the overall profitability of BT Consumer absent the estimated overcharge of SFV services.

As you say, the idea is that that gives an impression of -- or information on the kind of margins that BT would earn in a competitive -- in competitive services. So particularly towards the right-hand side of the chart, SFV services become a relatively small proportion of the overall output from BT, and so it is kind of -- this chart will be, or the EBIT margins will be dominated by bundled services and other kind of non-SFV services.

MR RIDYARD: I suppose my question would be, does this not sort of assume the answer to the question that we have in front of us? Because if you know those margins are abusive and/or excessive then clearly they do not belong, but that is the question we are trying to understand.

MR DUCKWORTH: Yes, I mean there is certainly a kind of circularity and logic here, but this has the assumption of my benchmark and the more or less 10% return on top of the recorded costs from that benchmark. So there is a degree of circularity in this, and that is accepted. But I think the point is on our case you cannot just take the EBIT margin overall and say that is a good comparator for returns under workable competition, because we say some of those returns are the result of excessive cost.

MR RIDYARD: Yes, if you are right about the excessiveness then there is circularity in that direction too, I can see that. But yes, it just -- neither view of the world provides an objective benchmark that we are looking for, it seems to me.

Dr Jenkins, did you have any comment on that?

DR JENKINS: Yes, I think just picking up some of the themes at the end of the day yesterday, which was around how we think about the 2006 estimate that Ofcom had versus the 2009 and what was going on there. I think that workable competition, effective competition has a number of features. It is not just price. It is choice, it is innovation, it is investment. In a sense, thinking about what happened between 2006 and 2009, where Ofcom was fully aware that the EBIT margins that BT was earning before it could bundle, so on the voice segment, had risen to those levels, but Ofcom did find that to be consistent with workable competition given the general benefits that were accruing in the market and the fact that market shares were falling through this period.

So that is -- I think the 2009 number therefore does have some weight, as in this is the point at which Ofcom then decides to remove all retail price regulation, even in the face of that, given the broader factors of competitive dynamics that you need to take into account in workable competition.

I was also reflecting on the discussions more generally about the point that was discussed, which is that we want to find a benchmark but we also want to think about persistence of any pricing. I think the reason I advocate the 25% as worthy of consideration is if you are thinking of, at any point in time, what sort of price would be considered excessive, almost on a one-off basis, then you do want to set an upper end of the range. But I understand the point that then says: "okay, but that might not be enough of a test", and so then you have potentially a lower number which -- and I have done a cross-check on 20%, which is akin to what Ofcom said in 2009, it is consistent with some of the evidence in terms of what Ofcom thought rivals would need to make to compete effectively in this market which they had already entered, these were not entry-encouraging elements that were what you need to be -- to have sustainable competition.

It might be that when we are thinking about this excessive pricing you do almost need two indicators in order that you are not having this difficulty, which is if you set an average -- some sort of average or lower level for a more persistent thing, that when people are thinking about how they set their prices, you end up curtailing, in a sense, their opportunities to benefit from investment, risk-taking, luck, and all of those things, without having some indicator, which is also helpful, because you want some indicator. So that is giving some guidance on what would constitute, even on a one-off, excessive pricing that you would then want to look into in detail.

MR RIDYARD: Okay. A number of interesting aspects there which I do want to explore here and now.

Let us just focus on this notion of the dynamics, if you like, of what Ofcom was trying to do or what one should try and do in a market like this. There are two -- you could paint sort of two stories of that.

One is that Ofcom decided that it was necessary to allow margins to increase in this market in order to generate a competitive entry and enthusiasm from competitors into the market, and then take the view that -- and let us be ever so simplistic about it and say Ofcom, before it sort of let go of the reins on regulation, the return on sales was around 10%. Then it said, we are fine to raise that to 20%, because that will stimulate competitive activity, and we think that is a good thing, because it is going to generate price and non-price benefits and ease the task of -- take the task away from the regulator and leave it to the market, all of which are good sounding principles. But then in the belief that over a period of time, let us say a short to medium term, once competition got established, they would bid prices down, and then margins would fall down, back towards the 10% level, just to put it at its most simplistic.

So that is one view of the world of how you are trying to regulate the market.

Another would be a view that, well, it just so happens that with a regulated outcome you can get away with a 10% rate of return, because it is all regulated, there is much less uncertainty there. Once you unleash competition it creates lots of good things, but it also creates lots of uncertainty, and firms will want to have compensation for that uncertainty, so we are happy permanently to allow the market to go up from 10% returns to 20% returns, because we believe that those dynamic benefits of competition are worth paying for, as it were, in terms of higher margins. Because higher margins do not necessarily mean higher prices if costs come down in the meantime.

I have painted two sort of caricatures there of how one might look at this kind of market in this kind of transition.

Is there any evidence of which of those views most closely corresponds to what Ofcom was about at that time period?

Maybe Mr Duckworth, you might want to comment on that first.

MR DUCKWORTH: Yes, I think we have some helpful evidence from the 2017 consultation, so -- I just need to get the right reference. It is {IR-C/2/31}.

These are BT's estimated EBIT margins for SFV services in 2016/17. So this is the consultation where Ofcom made provisional conclusions that BT was dominant in SFV services and looked at levels of prices or margins and potential levels of price cuts.

So the top line is, as the comment says, BT's current price for Line Rental, £18.99 including VAT, and Ofcom's estimate of BT's margin at that level of prices, and Ofcom's estimate of BT's level of margin at those prices -- I think we need to be clear that whenever you are looking at sort of estimates of margins for a single service, there is some cost allocation and cost attribution methodology underlying this, and so Ofcom did their cost attribution methodology. That is 32 -- sorry, 34-42%, and obviously Ofcom explicitly considered that was excessive, that level of margin.

At the bottom you have got a £10 reduction, including VAT in that price. Then you get BT with margins of 10%, which is sort of in line with what Ofcom said a sort of a cost based level of profitability would be akin to, but other CPs or other communication providers would, at that level of prices, have negative margins.

So BT looked at sort of intermediate levels of prices --

THE CHAIRMAN: Ofcom.

MR DUCKWORTH: Sorry, Ofcom, yes. So a £5 adjustment. Still BT would make 25% margins at that level of prices. The other communications providers, and I will turn in a minute to the kind of year assumptions underlying that modelling that other communication providers would make, lower margins of the order of --

MR BEARD: Hold on.

THE CHAIRMAN: Is this a confidential bit?

MR BEARD: It is yellow marked on the screen, Mr Duckworth.

MR DUCKWORTH: Sorry.

MR BEARD: No, understood. Everyone makes these mistakes, but just ...

MR DUCKWORTH: So it is significantly less and with different levels of downward adjustment.

So what you see there is Ofcom looking at both BT's returns and their estimates of rivals' returns and said, well, we need to take both into account. We do not just look at BT's returns. We need to, when we are thinking about potential price reductions, also consider the returns of other communications providers which will be lower.

If we turn to page {IR-C/2/28}, this is a list of assumptions. So here are the assumptions that Ofcom looked at when looking at rivals' profitability at those levels of prices. I will make sure I do not read out the confidential bits, but the first element is that Ofcom modeled this assuming that the rivals would offer a discount compared to BT. The second line, customer lifetime of about 8 years. Third line, significant acquisition costs. So this was a model of customer lifetime value taking account of the customer acquisition costs saying rivals who are acquiring SFV customers from BT will need to incur significant costs and then offer an ongoing discount on the Line Rental once acquired.

So those two factors really kind of explain why the rivals are showing lower profitability.

So Ofcom is faced with information on what it believes BT's margins are and what it believes the rivals' margins are and effectively it makes a trade-off and says: well, I will allow BT to make slightly higher margins in order to allow rivals who have these effective disadvantages to still remain in the market. That is kind of a very clear sort of trade-off between pushing prices down to a level which benefits consumers and balancing that with a level of prices which is required to enable competitors to expand by acquiring customers.

MR RIDYARD: We are very interested in this topic, this distinction between -- you might put it as between the marginal and the inframarginal suppliers and how you deal with it, this possible asymmetry between incumbents and challengers, and I want to come to that as a separate subtopic this morning.

But it does not really address the dynamic question I was asking about when this part of the market was -- when competition was encouraged to break out, and I know these points are related, but was there a kind of a glide path, as it were, in terms of rates of returns envisaged by Ofcom starting higher and then finishing lower, or was it expected to be a permanent increase in margins?

MR DUCKWORTH: I mean, I think there is an implicit assumption that customer welfare is increased through competition but I do not think that is necessarily in itself about -- where it would not need to be a reduction in prices. It could be an increase in quality.

MR RIDYARD: Yes. Or it could be an increase in margins could lead to a reduction in prices if something was happening to costs, so yes, many things could happen.

MR DUCKWORTH: I think there are some quotes in, I am trying to recall, I think potentially in the 2009 review where there are some statements by Ofcom about expectations of price reductions over time.

MR RIDYARD: Yes, okay.

MR DUCKWORTH: But very much from recollection.

MR RIDYARD: I do not want to ask an unfair question, I just wanted to know whether there were views on this.

Mr Matthew.

MR MATTHEW: Could I pick up? So on your question, I am not sure I have ever seen a statement from 2009 as to what they are expecting would happen to margins, at least I cannot remember it right now. So in terms of the evidence as to what they were thinking on that, the answer is I do not -- it is whatever the factual records might say, and I am not -- I cannot remember anything either way.

But just to make a couple of observations. Firstly, I think your latter characterisation is certainly how one might well be thinking about deregulatory processes of this kind, so you do not deregulate -- I am thinking more recently of my own experience where these issues were discussed in relation to wholesale access arrangements.

MR RIDYARD: I can see it is a version of the story that you prefer, but what I want to know is: is there any reason why we should prefer it as opposed to the alternative?

MR MATTHEW: I am just trying to get to the point that generally the idea is you create competition, then you get good things, or at least better things than you would have got with a continued regulatory monopoly without competition, and you do not focus "on are the profits high or low?" as your primary criteria for whether that has turned out well or might turn out well. You think about prices, you think about all the soft benefits.

In this case, I mean, obviously prices in Standalone Fixed Voice in the period were coming down from 2009, they continued to go down through to the claim period. There is a chart in this same document, I think it is A5.4, just to show that. I am afraid I do not have the document reference.

MR RIDYARD: Looking at the annexes ...?

MR MATTHEW: Yes, the annexes on the screen. There is a chart that shows ARPUs from around 2007 running through to the middle of the claim period for SFV services, and it shows BT's, and it shows a declining trend up to around I think 2013, and then it sort of levels off and then starts to go up a little bit and takes us into the other evidence.

In terms of how well it is working, from a perspective of a regulator prices are coming down, that is good, and there are a lot of other good things going on in retail competition at this time. Whether or not BT is earning -- yes, there we go {IR-C/2/20}. Figure A5.4. That describes the pattern of what was seen at the time.

I think part of the evidence that you do not worry about whether particular margins are high or low is the decision in 2009 that there is no SMP at all and to deregulate entirely, when, as pointed out by Dr Jenkins, the assessment was that the margins had grown substantially from 2006.

So I think what that tells me is there is nothing untoward about those levels of margins from the perspective of, well, that is -- those levels are unsustainable in terms of consumer interest and we must see them come down. It is the point at which you say: well, we really are going to let competition rip now, and the matches land where they fall. Part of that is obviously BT now faces a lot more risk in the retail sector, it is having to compete a lot harder. It is doing things like building a sports business to compete in those areas. There is a lot of innovation going on in retail telecoms generally and a lot of movement around in that market.

So in those circumstances, for me the better reading is the latter one, that you were just allowing competition to flow and BT gets what it gets in that environment, and if it does poorly, equally it cannot expect a sort of redress and a sudden reimposition of you get protected.

MR RIDYARD: Thank you.

Mr Parker, do you have anything on this or?

MR PARKER: I mean, I was not as closely involved with Ofcom and its decision-making as either Mr Duckworth or Mr Matthew.

MR RIDYARD: No, of course. I am not asking for a recollection on Ofcom, but maybe more general on the economic principles behind it.

MR PARKER: I think regulators, in my experience, have often looked at structural measures of competition when thinking about deregulating, so are the rivals sufficiently large and sufficiently well established that they can stand on their own two feet, is my impression of the kind of motivating factor. It is at that point that you might think of removing the regulation because then competition unfettered, you think the rivals are sufficiently well established to keep going and to be able to sort of continue to compete actively.

If that is right, then you might not be unhappy if the incumbent is still looking quite healthy in terms of margins, because that will give more fat, as we were discussing yesterday, for the rivals to go out and continue to be established. I think that probably just tells you that you cannot draw a huge amount of -- the kind of -- the margins that were being charged in 2009, because I think it is difficult to distinguish between the two hypotheses that you put earlier. I think there is something interesting in the fact that in 2006 the margins were much lower and you were still seeing entry. That is suggesting rivals were finding that healthy, that the margins that they could make were healthy enough despite having to start from scratch and make all the customer acquisition investments that they needed to make in order to get into the market.

I am not sure I have anything very obvious. I think one needs to look -- perhaps more generally, one needs to look at a range of evidence, not just in the 2006 to 2009 period but in subsequent periods, but I think we are probably going to come to other margin evidence as well.

MR RIDYARD: Okay, thank you.

MR DUCKWORTH: Could I just make one point. It is a bit of a follow-on from Mr Matthew's point, which was that Ofcom in 2009 effectively sort of stepped back and said: we are not going to worry about margins.

I mean, the first is deregulation means that you remove all SMP obligations, including the obligation to provide Regulatory Financial Statements, so Ofcom effectively lost visibility of margins from 2009 onwards, and obviously we lost visibility of margins on a kind of RFS basis.

But I think the idea that Ofcom at that point was completely hands-off is kind of belied by the fact that in 2017 they did look at margins and said, effectively: these margins look too high to reflect workable competition and so we are going to consider intervening in some way, and did intervene.

So there is clearly -- it is clearly not as simple as you deregulate and then you walk away from the market and you never consider whether you arrive at workable competition. Obviously Ofcom does continue to monitor even markets which are deregulated and, where they spot potential issues, will investigate.

MR RIDYARD: Yes, understood.

Dr Jenkins, sorry?

DR JENKINS: Perhaps if we go back to the table that Mr Duckworth took us to, {IR-C/2/31}. I think in 2009, when Ofcom was making a decision to deregulate, I think, just to finish on that point, they talked about efficiency benefits that had come through, which I think Mr Duckworth had also highlighted in his report, the increase in choice, the fact that customers were responding, switching, appeared to be engaged, so were responding to rivals' offers. Also they flagged that in the previous period there had not been that much investment by BT. BT had not felt the push that comes from competition to innovate and offer things.

So in 2009, in the context of those margins and the price falls they were seeing and the dynamism in the market, that was the basis on which I think they see the margin as being part of workable competition and an indicator of what you would expect to see.

So then if we come to this chart that Mr Duckworth brought forward, I think the margin that Mr Duckworth has chosen is the bottom line here, right, BT at under 10% margin, which is at the point where rivals would have been making losses. So that does not look consistent with Ofcom's view of workable competition at the time.

If we then take the top line, we see that the other core providers are making pretty chunky margins at that time. That is in the face of apparent higher customer acquisition costs. So this is including the additional costs that they are making, but there is no sign from this that actually there is a wedge between the allegedly dominant BT and the rivals in the market. So it is consistent with the position that says, actually, this is the way the market has evolved in terms of how these businesses are recovering their costs across the different types of services in the face of competition which is about transitioning people who have been Standalone Fixed Voice into bundles.

MR RIDYARD: Sorry to interrupt, but I did not understand your wedge comment there. The wedge?

DR JENKINS: Because the explanation that has been given about why BT had some advantage, you know, in the price leadership story that you cannot infer anything from the price leadership, is because the rivals had higher costs of acquiring those customers. Now, if that is true, that would show in the margins being lower, but they are not particularly lower at current prices, at the time current prices.

MR RIDYARD: I thought this table was showing the margins -- the rivals' margins were consistently lower than BT's margins.

DR JENKINS: I mean they are somewhat lower, but they are not down at 15% or something like that. They are --

THE CHAIRMAN: You have to be careful --

DR JENKINS: Sorry.

THE CHAIRMAN: We understand the point you make, and it is a question of whether the difference that one can see from the chart between BT and the rivals is significant or not.

DR JENKINS: Exactly.

MR RIDYARD: But if you had a narrow market where the incumbent really had terrific market power, because of some huge cost asymmetry, you could well -- I am just talking in general terms now, to be clear -- you could well find, well, competition is not going to fix this problem because of the asymmetry, and we do not like the excessive pricing because of all the bad things about monopoly pricing, so the answer here is to impose price regulation on this market, recognising that entry is not going to happen and competition is not going to fix it. That is why we have chosen to use regulation.

It is the asymmetry and costs that drive you towards the decision to give up on competition and impose price regulation instead, is it not?

DR JENKINS: I mean, I think -- I am not necessarily going to get into, well, why would Ofcom be nervous about the rump of customers that they considered were left behind, in some sense. But I think the question we have to answer is: is this evidence of excessive pricing across the board, including for the customers that Ofcom did not consider needed to be protected, so the Split Purchase Customers who make up the bulk of the claim.

So question is: what can we infer from this about what we would expect to see in workably competitive markets?

Whatever Ofcom decided to do in 2017, it is what is the evidence here, what does it tell us about what competitive margins should be in this sector? So that is what I am looking at here and saying if you just look at that, it does not mean -- it does not suggest to me that you cannot put weight on rivals' pricing. The other piece that confirms that is if we go down to sort of the £7 adjustment level, which is with BT having 20% margins consistent with 2009, and then we see much lower margins for other rivals, and -- not much -- much lower than their prevailing level at a similar amount, maybe a little bit less in terms of difference, and what we observed then was quite a lot of exit when a level pretty similar to that one was put into place.

There is another sign that even at the 20% level, that was -- it was hard to actually sustain workable competition at that time.

MR RIDYARD: Yes. Right. I obviously understand what you are saying there, which really -- that brings me on to the second item I had on my little checklist this morning, which was the inframarginal versus the marginal players in a market and how we treat that.

Sort of implicit in what you are saying there is that the competitive, the workably competitive price level should be one that does allow the challengers to stay in business, and the consequence of that, if the incumbent has advantages over the entrants, is that the incumbent is going to earn higher margins than the entrants.

The question then is: is that kind of asymmetry just a fact of life that we should have to live with and therefore say that the higher margin for the incumbent is just one of those things, or is it something which could deserve competition law intervention?

DR JENKINS: I think the benchmarking that -- because I think -- sorry, I will start again. I think this raises another question, which is these are multi-product firms, all of them, and we are here looking at one of the products, and then they have other products as well, and they are all doing potentially a bit different things. So we are trying to do quite a complex exercise with imperfect information.

When you then benchmark BT Consumer against the other entities, you find it is not out of line overall. So those other providers generally have some advantages elsewhere, which may be offsetting some of the fact that they have to work harder and incur more costs to compete here head-to-head with BT, and BT is competing elsewhere. So you may look at -- it is important to look at the margins on the particular product, it is quite hard to benchmark those unless we have the benefit of the sort of exercise that Ofcom has done, because you are very unlikely to get that information from publicly available documents otherwise, and otherwise you are going to be benchmarking across the board and then making a judgment on that.

MR RIDYARD: Yes.

Mr Parker, can I turn that one over to you, because I know you --

MR PARKER: We had a discussion on this.

MR RIDYARD: We did, and I think it might be nice to reprise it, because it is useful to go over it again, even if it does involve some repetition.

MR PARKER: Yes, I think my view would be as trailed last week. I think asymmetries can arise between incumbents and entrants, and the question is what is the sort of that asymmetry? So if it is that the incumbent has engaged in a risky innovation that has led to a market advantage for a period of time, then you would expect to see the incumbent making higher margins than entrants who are copying. An extreme version of that would be a patented monopoly product where you do not have any competition for a while and you can make very healthy margins, but that is a reward for the risk and innovation that you take and the fact that lots of people tried and failed.

But I think here -- I think one needs to dig into the source of any asymmetry. Here, for me, the source of the asymmetry is essentially BT is the statutory monopoly, it originally had the customer base, it did not have to acquire those customer acquisition costs in the same way as rivals, and I am not sure -- and we see that still being true for this customer group because the evidence seems to very consistently suggest that 80% plus of the remaining customer base have been with BT for a very long period of time.

MR RIDYARD: Yes. So what I am really interested in is how, in your view of this, how do you distinguish between good asymmetries and bad asymmetries, or acceptable asymmetries and unacceptable asymmetries?

MR PARKER: I think, doing the exercise that I have outlined just now, which is to say what is the source of that asymmetry, does it derive from good pro-competitive behaviour that needs to be rewarded? If so, one should look at -- especially think about having a higher margin. Because that is the genuine competitive margin there, because somebody has needed to --

MR RIDYARD: Someone has done something better.

MR PARKER: As opposed to a world in which, you know, the government has granted me a kind of: I am the only person allowed to provide economic expert evidence in the CAT for the next ten years, something that would hopefully give me a good market position, I would be able to make higher margins than other people. But I am not sure that one wants to say that is the outcome of a workable competition, so I think ...

MR RIDYARD: It would make the hot tubs less interesting.

MR PARKER: Perhaps I might have to sacrifice that heady prospect ...

DR JENKINS: Shorter though.

MR RIDYARD: Yes, but there could be quite a lot riding on this kind of distinction. So simply being there first or getting lucky on some past event, how do you ...

MR PARKER: I think in this particular case they were there first, but it is not because they got lucky or did something meritorious, it is because --

MR RIDYARD: They were just there first.

MR PARKER: -- 100 years ago they were there, and then the government decided that that is how we are going to operate the system.

So I would say there is a -- it is actually quite clear in this particular context, and I think one would want to say that in this context one should not, if you like, give BT the credit for its asymmetry, but that does not mean that that is -- it seems to me that is not a general finding for all dominant firms, many of whom may have achieved their position originally through innovative activity, and I think you need to make a distinction there.

MR RIDYARD: Okay.

DR JENKINS: Could I just add a point there, which is just to remind the Tribunal that from 2008 the Class Members that we are talking about are split purchase, the majority of whom have been acquired by a rival to BT at that point in time. So I think this idea that BT has this, as I have said before, hermetically sealed group of customers that, come what may, cannot be -- are impossible to target from the rivals, I just do not think the evidence supports that characterisation of the benefits that BT has at that time.

MR DORAN: Could I just ask you, Mr Parker. BT, as some sort of institution, might have this conferred benefit, but its shareholders, who are brought in, are in a rather different position, are they not? It is they who ultimately take the risk of this.

MR PARKER: Yes, and so I should probably refer you to the expertise on the bench behind me, but in my experience of, say, cartel damages cases, there seems to be a distinction drawn between the firm as the entity that is potentially putting up the prices and gaining the benefit of that, and therefore any cartel damages claimed looking at those impact -- sorry, I am thinking about -- you should think about the claimant. So the claimant firm and then the shareholders of the claimant firm, and generally the analysis seems to stop at the shareholders and the claimant firm.

I feel I am very much going beyond my expertise here. I am not sure there is an economic answer to the point, so I think I should perhaps cease and desist at this point.

MR DORAN: Thank you.

MR MATTHEW: Could I just ...

MR RIDYARD: Please, yes.

MR MATTHEW: Firstly on the general point, my view is workable competition is consistent with asymmetries of a variety of kinds. That is what, in competitive markets, people are always trying to find a point of differentiation, that is the profit incentive that drives them, and you can get a lot of difference, and you do see that in retail telecoms as well as many other markets.

So just going back to how do you draw a distinction between good and bad asymmetries, that is very hard.

What you try to do is pick out different types of what would be competitive situations and say, well, in this one, one firm's extra profits is okay, in this one is not. That seems to me to open up a very broad scope of possible intervention on firm's prices that, going back to the chilling discussion, would be a very significant step.

In terms of the statutory monopoly, this is the differentiating feature here. As I comment in my report, I do agree with Dr Jenkins. In retail competition in particular there has been aggressive competition with large effect for at least 20 years, and in terms of the customer base, which is where Mr Parker's comment comes from, most have either, in fact I believe the vast majority have either moved to another supplier or at least moved to a Dual Play package, so they have made some sort of engaged decision.

I suppose just as a comment, the ones that are left obviously may not even be the same customers as they were 10, 20 years ago. They are changing themselves. So they may have been with BT for a while, but their decisions earlier on might have been at least partly influenced by some of these features.

So I do not think this is a case to compare with other situations where somebody just privatises a monopoly and allows it to exploit that position freely where, if there was no sector regulator, usually there are, then you could see, well, that is a case where you could get some quite gratuitous high pricing, but this is not one of those instances for me.

Finally, just to comment on Mr Duckworth's point about the Ofcom monitoring. I do agree Ofcom did not deregulate in 2009 and say: that is the end of any interest we have in retail markets. They do keep an eye on it, they were monitoring it, and that is indeed one of the ways in which they picked up the themes that led to the 2017 review.

My observation is that is what they did, and when it came to 2017 I do not think they started off with: there is a particular margin that has been exceeded here. They started off with some observations of: well, wholesale charges are going down and we are not seeing Line Rentals going down, in fact, they are going up, and it is time to look take a look at that because these are customers that they perceived to be vulnerable, particularly elderly, and made a decision in that context that -- I think they characterised it very well. It was a case where they did not see competition was working well for those customers and decided: that is the instance, that is the segment where actually we are going to reverse the usual presumptions of allowing competition to do its work and instead just bring in a price cap or a price intervention, and that is what they did.

The fact that that was linked to the particular nature of that group, as Ofcom saw it, is revealed by the different treatment between Voice Only Customers, who were the elderly ones that were the primary concern here, I would say, with the Split Purchase Customers who continued to engage, were paying the same prices, but were not in that group of people where they need special protection and it is better to allow the market to serve them.

MR RIDYARD: Okay. Thank you.

Mr Duckworth, did you want to comment any more on this topic before we move on to the next?

MR DUCKWORTH: No.

MR RIDYARD: Thanks.

My next -- the last item on my sort of overnight checklist was looking at the -- we will look at benchmarks a bit more in a moment, but looking in general at the benchmarks, the various benchmarks that have been proposed here, particularly I am thinking about the other utility companies, the other telecoms companies.

One thought that just occurred to me on that was when we look at a benchmark for, let us say, another utility company selling a retail product, is there any way of, or did any of the experts look at the variability of returns within that individual provider? Because it occurred to me it might be quite interesting, if one could find some information on this, to know -- let us say that that the margin of an energy retailer was 10%, but knowing also how that 10% was composed between different subparts of its business. Some of those returns might be 30%, some might be 2%.

Because in a way that is -- what we are doing in the current case is we are saying -- we are looking at BT Consumer's margins overall, and then within that we are bringing out one sub-segment, which is believed by the CR to be a separate market, of course, and highlighting that particular market, and I just wondered whether, in the comparators, we have done any analysis of the variability of sub-margins within the overall margins.

Dr Jenkins, is that something you have thought about or researched?

DR JENKINS: I think we touched on that just a little while ago. I certainly have not dug into the utility benchmarks that Mr Duckworth suggested. I do not think they are good comparators for the situation we have here. As I said, it is very hard to get information on sub-products. To the extent you might get it, it is very likely to be at the gross margin level, because in a sense --

MR RIDYARD: Yes, of course.

DR JENKINS: -- when you allocate the cost, and then you put a different margin on that bit of the cost, it is almost like you say: we have got these common costs, we are going to use this allocator, put it into this product; now, that bit of the call centre earns 8.9% and the rest of it can earn more.

So it is quite -- it is not something that I think is commonly done by businesses.

MR RIDYARD: No.

DR JENKINS: So, yes, I have not got a lot to help you with that question, other than saying: hence that is looking at benchmarks for similar businesses overall, and the inference would be businesses think about actually earning a similar margin across the board. That is the implicit approach.

Actually in my cost allocation approach that I have done, it is important, because I am actually saying: okay, what element of that cost is being recovered elsewhere in the business which would be attracting the more general margin that you would expect to see for that part of the business?

MR RIDYARD: Yes, okay.

Mr Duckworth.

MR DUCKWORTH: I am not aware of any sort of cost attribution below a sort of retail business for these companies, and so there is not, as far as I am aware --

MR RIDYARD: Sorry to interrupt, but I suppose I was more interested in just looking at the variability of gross margins, maybe this is not available either, looking at how gross margins vary from one customer segment to another within the comparator businesses.

MR DUCKWORTH: It is not something that I am aware of.

MR RIDYARD: Okay.

DR JENKINS: On that point, I think it is a while ago now, but the energy market inquiry did look at different supply margins across different types of customer groups, which is perhaps not dissimilar to this type of concern that the regulator Ofcom had had, and then the Competition Commission investigated, which showed there were variations in margins depending on the customers who were on standard tariffs versus those who were taking up more competitive tariffs, and they were 10/15%. I could go in deeper and have a look at that if that would be of interest?

MR RIDYARD: Maybe, yes.

I think one topic that we have touched on but I would like to go on to in a bit more detail is looking more about the specific pros and cons of the different benchmarks that have been suggested in this case.

Maybe, Dr Jenkins, you could kick off on this by just reminding us which benchmarks you have used and why you have chosen them and why you think they are the appropriate ones.

DR JENKINS: Yes. The benchmarks that I have collected are, first of all, two different datasets of telecommunications companies. One is more worldwide and the other is European based. That is, if we go to {E/17/209}, that Table 6.2 provides the summary of the results from the EBIT margin benchmarking of firms in the relevant industry classifications taking the 90th percentile. It is Annex A5 of my first report for the detail behind each of those, so you can see more information about the distribution for each of those.

One of the comments that Mr Duckworth has made is that obviously, because I am taking telecommunications companies more broadly, that it includes vertically integrated companies, so it includes the network element in these.

MR RIDYARD: Yes.

DR JENKINS: In the JES I have had a look at what the capital intensity measures are, to see whether the businesses that I have benchmarked here have higher capital intensity than BT Consumer, with the measure of capital intensity I can get for BT Consumer, which includes Plusnet and EE. For the European telecoms businesses, from Professor Damodaran's database, it is -- the capital intensity is quite similar. For the MSCI World index, the capital intensity is somewhat higher for those firms.

So that was for looking at similar industry comparators.

Then if we go two pages over to page 211, {E/17/211}, this was where I looked at the question from the perspective of businesses with similar financial metrics to BT Consumer. So that takes a broader range of businesses from different sectors, but these are businesses which have similar capital intensity measures. I have proxied that with the capital intensity measure from a broader business than just BT Consumer, including Plusnet and EE, because that is the only segmentation we have for the actual capital employed. But then for BT Consumer itself I have used the two measures, B and C, which capture elements of --

and these ratios you can get from publicly available information for a set of comparators. So it is depreciation and amortisation to OpEx and to revenues, so they give you -- just for your reference, paragraph 6.106 of my first report explains those measures and what they mean.

So the depreciation and amortisation to OpEx, that ratio gives you an idea of how important capital is to operating costs in a business, and D&A to revenues is, in a sense, what sort of revenues are being generated from the capital base. So I have used those as the two measures of capital intensity as my comparators.

THE CHAIRMAN: Sorry, just so I understand that. You have got the capital intensity stated as a percentage in A. Then you said -- did you just say that the B and C were measures of capital intensity?

DR JENKINS: So one of the challenges we have is that for BT Consumer itself, which is the entity we are most interested in here, BT does not report balance sheet information. So what you would normally use for a capital intensity measure, which is a measure of capital employed, I only have that for BT Consumer, including EE and Plusnet.

So that metric A is based on that. Metric B and C are then what I can benchmark for the BT Consumer business itself and for that I have to use depreciation and amortisation as my measure of the capital metric for that subset, and depreciation and amortisation are telling you of the capital base how much is being used up each year in an accounting measure way. So that is why I have used that as my capital measure.

THE CHAIRMAN: Is the purpose of this with the different percentages to be then what, a proxy or a marker for a reasonable margin?

DR JENKINS: Yes, that is right, because in a sense, if you think about investors there might be two ways they think about what the right margins might be to be earned. They think about, what do other firms in this sector return, so that is the first approach I took. Then the other is, given how much capital is invested in a business what is the right sort of return to expect from it. So it is quite standard in a corporate finance approach to use comparators from beyond a specific sector but looking at the capital employed, the amount of capital and the return on that capital.

So that is what we are trying to proxy here and so I have looked at both those angles to benchmark businesses that would be similar to BT Consumer.

As we have discussed, what I have presented in these tables are the 90th percentile returns from the benchmark companies derived in the manner I have described.

THE CHAIRMAN: I see, thank you.

MR RIDYARD: Mr Duckworth, what is your criticism of this approach?

MR DUCKWORTH: I think the easiest place to start is the benchmarking with telecoms companies and, as Dr Jenkins set out, one of my key criticisms is that we are looking at the capital employed required to deliver BT SFV services, not even BT Consumer's services as a whole but BT SFV services. We are agreed that is an asset light activity. It does not require a huge amount of capital employed. To then go and compare with the equivalent of BT Group which is not only the retail activities of BT but also the network Openreach, and I think everyone accepts that provision of network services is a capital intense business. It is completely different from asset light business.

So, looking at returns for a set of businesses which are quite capital intense, and so need to reward the shareholders for all of the investments in the ongoing network to then determine a margin for SFV services, where we are all agreed the assets required to deliver that are included in Openreach and the price that BT Consumer or the transfer charge that BT Consumer makes to Openreach includes a return on capital employed for Openreach, it just seems a completely inappropriate comparator.

MR RIDYARD: Would that problem be fixed by stripping out the telecom companies which were just network businesses from those which were not?

MR DUCKWORTH: That is the approach effectively I have taken in my first report which is to try and focus on operators which are in some ways similar to BT Consumer, so people who rely primarily on access to the Openreach network and pay the regulated price of the Openreach network, so the likes of TalkTalk and Sky in their retail provision. Sky and TalkTalk have not built their own network so they are relying on the Openreach network in the same way that BT Consumer is reliant on the Openreach network.

MR RIDYARD: Understood. But is it possible to get other telecom operators from other countries who operate in a similar mode?

MR DUCKWORTH: I think the UK is quite exceptional in the kind of success of access-based competition and so you have large providers such as TalkTalk which has been built on access-based competition. I am trying to recall if there are other obvious comparators. I think one comparator could be mobile virtual network operators who have a similar business structure in mobile service provision where they provide effectively the retail services but rely on network services bought from a kind of host network. So that would be one potential comparator.

But looking at the comparators that Dr Jenkins pulls out from telecoms operators, they are generally vertically integrated operators. In one case I think there is Inwit initially which does not even have a retail provision arm. It is effectively an infrastructure that then provides infrastructure to other providers who provide the retail service.

MR RIDYARD: Are you saying that that it is not possible to identify a number of non-UK telecom companies who have a similar operating set up to BT Consumer or ...?

MR DUCKWORTH: I do not have the information to hand. I think it would be potentially possible but I think you would need to spend a certain amount of time going through and identifying whether there are similar asset light operators which are quoted, because the other reliance is on having sufficient financial information on those businesses. In the UK through Companies House you can get information on non-quoted businesses. In many jurisdictions it is more difficult to get information on the underlying accounts for non-quoted businesses and so you tend to focus on quoted businesses which tend to be large intensive businesses because that is why they are quoted in the first place.

To kind of follow up on the second part of that point, Dr Jenkins has then conducted a cross-check and said, let us look at the capital intensity of the sample of telecoms businesses that she has identified and compare them with a capital intensity of BT Consumer including EE and Plusnet, and I think the inclusion of EE there which is a mobile network, again capital intensive, shows that that is not a suitable cross-check to show that is the appropriate level of capital intensity for provision of SFV services.

MR RIDYARD: Fine. Dr Jenkins, I think those criticisms, the nature of those criticisms is clear enough. Do you want to say anything more?

DR JENKINS: I give the reference in the JES of 7.2.18 {E/49/164} where I did investigate whether the capital intensity measures of the telecoms firms I benchmarked did look dramatically different to that of BT Consumer. One of the challenges with all of this is how you actually capture capital employed, and that while we have used EE and Plusnet in that measure, which I acknowledge may not be a perfect benchmark for BT Consumer, without those elements BT Consumer would still have intangible value associated with the brand which is just not captured currently in that measure, so it may not be too out of line when you include EE which does actually capture some of the brand value because there was a transaction which actually gave a value to it.

So these are all imperfect measures but I have used a range of imperfect measures that generally give a similar direction for all of this. So while I have benchmarked against, as I have said, the capital intensity measure based on the broader BT Consumer business, I have also then used measures that do not include that and you do see that the margins were higher on the capital intensity including EE and Plusnet above the margin that I was suggesting would be the 25% benchmark.

So it is not straightforward to derive these benchmarks for return on sales, so I have done an exercise which is quite commonly done, as I said yesterday, for when considering these questions, and looked at businesses that I do think will be meaningful for benchmarking the service and the activity that BT Consumer is involved in.

MR RIDYARD: Thank you. Let us take a break there and we will move on to Mr Duckworth afterwards.

(11.41 am)

(A short break)

(11.57 am)

MR RIDYARD: Mr Duckworth, can we ask you to just present your proposed benchmarks here, and, similar to what I asked Dr Jenkins, can you explain what you have done and why.

MR DUCKWORTH: Could I, before I do that, just make a couple more observations about Dr Jenkins' approach.

MR RIDYARD: Sure, yes.

MR DUCKWORTH: One of the issues that Dr Jenkins has raised is if you look at the balance sheet for BT Consumer with or without EE, balance sheets do not tend to necessarily identify all of the sort of intangible assets, such as brand, maybe customer relationships, that can generate returns. So she says do not necessarily look at it, or if we include EE, maybe that is a good proxy for -- the balance sheet including EE, maybe that is a good proxy for the capital intensity for BT Consumer, because BT Consumer has some intangible assets which are not recognised on the balance sheet.

My main criticism of that approach is that it goes for every other company. So when you are making comparisons based on capital intensity you can uplift that for BT Consumer by saying it has some intangible assets. But when you use that capital intensity to compare with the book capital intensity of other companies, you are not comparing like with like, because you are not taking into account the intangibles which are not recognised on the books of the comparators either.

We can see those intangible assets are likely quite significant. I think if we turn to my reply statement, it is on {IR-E/7/54}, paragraph 5.97. So I say there we are looking at a -- the MSCI World index is an index of large quoted firms, and so we have a market valuation for those firms which we can compare to the book value, so there is a price to book value ratio for the MSCI index as a whole, and it is 2.81, suggesting that the market recognises that the book value of all these firms on average is a significant underestimate of the kind of true asset value underlying those firms.

So when you are making comparisons, there is a significant measurement area here, and while BT Consumer may have intangible assets, and you can allow for those, you should also potentially uplift capital intensity of all of these other businesses to reflect their intangible assets.

I think this problem, this measurement problem of saying there are potentially significant intangible assets is effectively the reason why we go for a return on sales approach, because we have large uncertainties in understanding what the true capital employed is.

Dr Jenkins' selection of comparators says -- assumes that we can measure capital intensity relatively accurately both for BT Consumer and the comparators in order to select companies with similar capital intensity. But that seems to contradict the fact that we say we are doing a return on sales approach in the first place, because we cannot measure capital intensity.

So we are either in a world where we cannot measure capital intensity and therefore selecting comparators on a proxy for capital intensity is the wrong thing to do, or if we do know what capital intensity is, we should just move back to a return on capital employed approach.

So I think there is a kind of inherent contradiction in Dr Jenkins' approach of using capital intensity to select comparators for a return on sales approach.

MR RIDYARD: Any brief ...

DR JENKINS: I will be very quick.

I do not agree with the latter point that Mr Duckworth just made. On his former point, I agree that it is hard to get a good estimate of capital employed for BT Consumer, and I gave the reference to the JES where we debate the merits of those, but it is hard to do. That is why I also use the other measures of capital intensity for BT Consumer which I think are benchmarkable.

So to the latter point Mr Duckworth made. The fact that we do not have capital employed measures for BT Consumer, that if we did have that it would most likely only be tangible and it would not capture intangibles, so would not be appropriate as a measure of the relevant economic capital to do a return on capital employed analysis, does not mean you cannot use other proxies for capital intensity to benchmark return on sales. Because, as Mr Duckworth said, it is because we do not have good information we use that proxy to then look at, well, what are the returns on sales that we see for businesses with similar proxy measures. So I do not think it is a contradiction to have done that.

MR RIDYARD: Thank you.

Mr Duckworth, can you now take us to your comparators.

MR DUCKWORTH: Yes. If we turn to my first report, {IR-E/6/81}. I think we have looked at this chart yesterday. So this is kind of the point estimate I use, and we discussed this at length, but the returns on SFV -- or SFV services were effectively residential retail fixed voice services up to the point of 2008/9, and I have selected a benchmark for the last year in which these prices were regulated, and obviously we discussed where the level of prices were regulated, to be precise, and once the level of prices was no longer regulated there was an increase in the reported EBIT margins over time.

Then in terms of comparators, if we move on to page 82. So my choice of -- 85, sorry {IR-E/6/85}. My choice of comparators is much narrower than Dr Jenkins' and a smaller set of comparators. I have tried to select comparators which most closely reflect BT Consumer's, and, in particular, SFV services' comparator, that provide similar services based on a similar cost structure. That is largely reliant on access to Openreach's network, so kind of a retail business on top of that.

I show five comparators. There is Virgin Media, which is a cable operator which is, if anything, slightly more capital intensive, because they have a cable network as well. Sky (UK and Ireland), because they do not report separate data on UK alone. The Phone Co-op, which is a relatively small operator. I do provide information on the revenues over the page. TalkTalk, which is effectively -- sorry, if we go back to the chart. TalkTalk, which is pretty much a pure play access based operator offering voice and Dual Play services using the Openreach network, and Utility Warehouse which is a sort of multi-utility player providing telecom services as well. I sort of present the EBIT margins of those operators from 2010-2019, which was the latest data available when I made this report, and the averages for these operators over time which are the dotted lines.

What we see is Sky with significantly higher returns than the other operators, and the other operators with returns between 2% and 7.4%. I would say I think the Phone Co-op actually exited the market, which is why there are no returns on the Phone Co-op past 2017, but obviously TalkTalk, Sky, Virgin Media and the Utility Warehouse remained in the market, which, to me, is suggestive that they are providing at least sufficient compensation to their investors for their investors to maintain them in the market. So those are informative levels of returns to understand what investors require from operators in similar markets in order to remain in business.

I place less weight on Sky with a higher return, because that is principally a pay television business. Obviously it entered the market a significant amount of time before, but has been innovative in terms of providing pay television. It took what are generally regarded as significant risks in entering that market, and is likely to have significant intangible assets, such as content rights, but also brand and subscriber relationships which potentially inflate their return on sales.

If we turn to page {IR-E/6/87}, we see at the top in Figure 8 the sort of revenues from these companies. So Sky has obviously the largest revenues, but a high proportion of those revenues are from pay television. Virgin Media is effectively a large-scale player, and TalkTalk and Utility Warehouse being significantly smaller operators but still with substantial scale, and, as I say, Phone Co-op being a very small operator which eventually exited the market.

I also present in Table 22 -- so the benchmarks up to now are based on public information. Ofcom also requested information from providers of SFV services as part of the 2017 investigation. The Post Office was able to provide EBIT margins for SFV services alone for four years, and I obviously will not read out those estimates of profitability. They are also informative.

Finally, on the next page {IR-E/6/88}, I consider allowed margins in the retail supply of other regulated network services. So I look at the postal sector in paragraph 5.132(a), where Ofcom considered that the Royal Mail required -- or an EBIT margin of 5-10% would be consistent with a kind of reasonable commercial rate of return.

In 5.132(b), the CMA looked at margins on retail supply of electricity and gas sales to domestic customers and found that those returns were at 3.5%. When actually setting a charge control or a price cap, it set a significantly lower EBIT margin based on a return on capital employed approach, and Ofwat, when looking at the net margins required for retail water businesses, set a very low net margin of 1%.

I do not place a huge amount of weight on those utility comparators. Just to note that the margin I chose is very much the upper end of the range of those utility comparators.

MR RIDYARD: Why are the energy retailers not a good comparator to telecoms?

MR DUCKWORTH: I think it is, in part, and this is slightly backward looking, but the degree of innovation potentially in the sector or the investment required in order to provide services. I recognise that there is potentially more innovation in service provision in the telecoms market than in, say, the energy supply market, which is relatively -- a relatively undifferentiated product, although we are starting to see some differentiation with the introduction of smart meters in energy supply, but certainly in this period it was a relatively commoditised market.

MR RIDYARD: Okay.

Dr Jenkins, what is your main criticism of this approach?

DR JENKINS: Yes, so I think I will not go back over the 2006 versus 2009 point that we have already discussed quite extensively, so that is the foundation for the 8.9% already being problematic.

MR RIDYARD: Yes.

DR JENKINS: I think Mr Duckworth has selected relatively few comparators. I note that one of them, Virgin Media, is a vertically integrated telecoms company. So that basic principle which Mr Duckworth took to his choice of comparators did encompass vertically integrated players as being relevant for that comparator, and, in a sense, the approach I took was to look at a broader set of telecoms companies than the small group that Mr Duckworth has selected. I would see no grounds for ignoring Sky in that assessment. It was very active as a main competitor of BT during this time period so it is clearly relevant.

Possibly one of the main differences between Mr Duckworth and myself is his focus on average levels rather than 90th percentile. I mean, it is obviously also the range -- the number of comparators, but also this piece that says: okay, what you should be considering to be the right level is the average that is earned in this process, and including businesses that go out of business in that range. Because I think actually from the broader range that I have taken, say, the European telecoms sector, you probably see a similar range. I mean, there is more range at the bottom and there is more range at the top, and probably the average is somewhat higher than the six that Mr Duckworth has chosen, but in a sense, the principle is, well, from this distribution, how do you decide what is the right sort of benchmark to take for the question that you have in front of you?

So I would say there are two things. One is I think there are too few comparators. You cannot reject any one of them because they do something slightly different. They are all useful comparators. I would advocate using a broader range and then thinking about where in the distribution is the one that is going to be most informative for excessive pricing.

In terms of the utility sectors, I just think the conditions are so different that it is really not that helpful. One of the other considerations for the energy comparisons is that there is a much bigger proportion of the stack that a retail supply company buys in, or at least that was how it was thought of at the time they were setting those very narrow rates of return, and one of the things -- the consequences of all of that was because of this view about how wholesale energy was bought, and whether it was bought on the spot or hedged, with very low operational margins allowed, I think the recent work, which was also looked into by colleagues of mine at Oxera on behalf of the board of Ofgem, showed there was not actually sufficient operational margin to deal with the risks that were apparent, and that is what actually then happened, because you saw a huge number of exits that caused a lot of trauma in that market and lots of unserved customers.

So I think perceptions of what is the right amount of margin for effectively a workably competitive market, you have to be very careful at using regulated outcomes without looking carefully at consequences. With Royal Mail, I think, as I have set out, the 5-10% margin, you just need to be really careful with Royal Mail. It is a complex business. It is again struggling, facing a lot of change. It has a very different business model, it is a people network, not a capital network, and the benchmarks that Mr Duckworth has focused on are ones that are associated with Ofcom being able to ensure it fulfils its duty to ensure the universal service obligation is met, as opposed to workable competition in a postal market.

So, yes, one can think about all of these things. I would certainly agree with Mr Duckworth to put little or no weight on Royal Mail or the utilities, and I would broaden the comparators he has used from the telecom sector.

MR RIDYARD: Presumably, Mr Duckworth, you would have liked to have more lines on your chart but you could not find ones that you thought were suitable?

MR DUCKWORTH: Yes, that is right.

Just turning to the point about capital intensity, on page 86 of my report {IR-E/6/86}, Table 21. So I do compare capital intensity, because I look at capital intensity reported in the Regulatory Financial Statements in 2006 for retail residential voice services, and it shows a very low capital intensity indeed. I do not place a huge amount of weight on that. Obviously I have taken an approach that it is an asset-light business and you cannot necessarily measure capital intensity very well.

But, yes, clearly, as Dr Jenkins says, Virgin Media has much higher capital intensity than the more sort of access-based operators, such as TalkTalk, Sky, Phone Co-op and Utility Warehouse. Even those access-based operators, because they were for significant periods of this time using local loop unbundling, they were required to invest in assets in order to deliver -- or network assets in order to deliver services over local loop unbundling, which BT Consumer did not have to do. BT Consumer paid for those network assets through the cost of sales.

So the capital intensity for, all else being equal, for -- even the access providers will be higher than for -- access-based providers, it is probably higher than for BT Consumer. So, if anything, the returns that investors would require are likely to be higher for companies like TalkTalk and Sky on the provision of their sort of telecom services than would be required for BT Consumer.

THE CHAIRMAN: Can I just ask in that context: just dealing with the Virgin point specifically, which Dr Jenkins adverted to, she says: well, it is vertically integrated. That rather cuts across your design it is not a true comparator.

MR DUCKWORTH: It is not a true comparator.

THE CHAIRMAN: So what do you say about that?

MR DUCKWORTH: I say, if anything, that will lead to the return on sales as measured for Virgin Media to be higher than the required return on sales for BT Consumer, and so including it effectively as a data point pushes up, if anything, my estimate of the return on sales above that of BT Consumer. But I accept it is not a perfect comparator for those very reasons, and Table 21 clearly shows that the capital intensity of Virgin Media is far above those of the access-based providers.

THE CHAIRMAN: Yes.

MR PARKER: Mr Ridyard, can I have ...

MR RIDYARD: Yes, sure.

MR PARKER: Two thoughts, perhaps. One thought is in some ways -- Dr Jenkins was talking about the 90th percentile point, and I think it is probably worth decomposing the differences between us into two parts. There is whether you take the mean or the 90th percentile, and there is if you take the mean, what should that mean be.

If you look at the tables in Dr Jenkins' Annex 5, and we do not need to go through them all, and I have not done a kind of -- I have not added up all the numbers precisely, but it seems to me the average of the means that you get in all those tables was probably somewhere around 15%. So that would suggest sort of two-thirds of the difference between us is because Dr Jenkins is using the 90th percentile, whereas we are using the mean. That is kind of one decision.

Then there is the considerably smaller, the remaining bit, the one third is to do with the choice of comparators for the mean. It seems to me that there are never any -- you want the best -- for me, you want the best comparators that you can get, and I am not sure adding any more data points to get a wider range of not, I think, terribly good comparators really adds to the sum of human knowledge in this instance.

I mean, I think I would probably, of Mr Duckworth's data points, I would probably place the most weight on TalkTalk and the Post Office in relation to the closest comparators that you have in terms of the question we are really trying to explore, which is BT SFV services. TalkTalk there, not perfect, because it also does broadband and Dual Play as well. I think the point about Virgin, yes, I agree with the comments made by both Mr Duckworth and Dr Jenkins on that, and Sky I think is in a similar position.

MR RIDYARD: Dr Jenkins, do you agree on the two-thirds/one-third characterisation that Mr Parker just made?

DR JENKINS: Yes, I think that is probably about right.

MR RIDYARD: That is useful.

As regards the comparators, I think we can all see that there is no great solution here, and there is a problem with a very small sample because -- and the variability within those, problems of quality as you widen the sample out to take it through.

I think we will just have to -- I think all the issues there have been well exposed, but we are still left with some tricky choices.

THE CHAIRMAN: Can I just ask two questions, please.

First, Dr Jenkins, just on the question of TalkTalk, which I suppose, from a sort of rather intuitive or instinctive layperson's view, that is a bit like -- that is pretty much like BT, would it not be right, given that even if it is not to be the exclusive comparator, would it not be right to give the TalkTalk margin particular weight, as opposed to sort of generally taking it into account, as I suppose you have done, but you have been looking at other comparators?

DR JENKINS: Yes, so I think the question again, it comes back to what is the -- what are the margins you would expect to see in a workably competitive market, and I guess, picking one comparator and giving it particularly strong weight, I think is very problematic in this environment. Because TalkTalk's approach -- I mean, TalkTalk decided to cease to market Standalone Fixed Voice at a certain point towards the beginning of the claim period and targeted entirely the bundle market.

So then you could say, and indeed we do say that, let us look at bundle margins. But that is fine, we can look at that as well. Certainly we think those are a floor for, if we are going down to the segmental bases, of what can we infer from different products. You know, you might then put more weight on the Sky metric, because Sky, like BT, was offering a range of products to attract customers to its offerings, including its voice offering.

So it is very hard to benchmark against one provider when what we have here is precisely a differentiated market, a market where the rivals, the workable form of competition we observe is differentiation, which includes price differentiation, product differentiation, and differentiation therefore of the offer, including consumers, the customer service that ...

So that is why I have gone for a broader set, because from that law of large numbers piece that you are actually washing out some of the idiosyncrasies that you can get, which you really need to be careful of once you are down at one single comparator, you want it to be a very, very good comparator if that is the route you are going to go.

THE CHAIRMAN: Would you like to come back on that briefly, Mr Duckworth, that you have just got to look more broadly because there is no perfect comparator?

MR DUCKWORTH: I think there are two points, one of which is a discussion about differentiation. Differentiation is important in this market, but as an investor differentiation is a means to an end. The investors are not going to want different returns just because you have got a differentiated strategy in the case of TalkTalk, which may be not investing in pay television, having a lower cost base, offering -- with that lower cost base offering more competitive prices. That in itself, I mean, there may be some elements of kind of more or less risk associated with that, but that in itself is not going to change the investors' required return from investing in assets with TalkTalk compared to investing in assets, similar assets, with Sky. There might be some second order effect around the riskiness of investing in pay television where you have large up-front costs, etc..

I think the second point is about bringing together a huge amount of data and using that to try and come up with a kind of robust estimate. I think I am sort of in agreement with Mr Parker that there is -- you can bring together a large amount of information. I think Figure 3 in Annex 4 of the Joint Expert Statement, so that is {OR-E/49/267}.

So Dr Jenkins showed this chart earlier, and I think the red line kind of shows broadly where Dr Jenkins comes out. She assumes a capital intensity of about 1, and the Y intercept is 9.5%, and then you add another sort of 4% for the capital intensity of 1, and you get something like 13.5% as a kind of average return for that level of capital intensity.

I sort of disagree on the level of capital intensity, but that is effectively what is coming out of her analysis. If you just look at the level of median returns, and you look at very asset-light businesses as recorded on the balance sheet effectively with zero assets, you cannot get much more asset-light than that, you get a return of 9.5%, which is broadly in line with my estimate.

So I think we are not actually that far away or that far apart in terms of what a view of average means. Dr Jenkins is taking sort of a look at the average at a level of capital intensity and, you know, measured on a book value of 1. I am saying it is probably closer to zero. This is an asset-light business and you get a likely return of around 9.5%.

So in terms of averages, I do not think we are a million miles apart. Because obviously there is the question of dispersion around that average and we just take fundamentally different approaches about that.

THE CHAIRMAN: That was the other question I wanted to ask. Because particularly with TalkTalk I think, there was a really big spike in the earlier part of the period, up to 16.9% or something. So how does that -- is averaging it the answer there, I mean, unless something was raised with the parties later on, unless we have got to conduct this exercise for every year of the claim, which admits to the possibility that if all other factors were in favour of the Class Representative, there might be some years where the price is excessive and some years where it is not, but I do not want to invite that debate now.

But it is quite a big element of dispersion ...

MR DUCKWORTH: I think that is right, you do see kind of returns bumping around. If you look at Figure 3 in my reply report, so that is {IR-E/7/59}. If you look at returns at the BT Consumer level, they are also bumping around. Dr Jenkins says, well, in 2014/15 they are almost 20%, so that is kind of supportive of her benchmark. I say potentially you need to adjust for excessive pricing in SFV, but obviously with that slightly circular logic involved. But that was kind of a high point in even the unadjusted returns. Is that high point just, for example, changes in Openreach charges in that year which then took some time to feed through into competitive prices, or some one-off pricing change which proved to be not sustainable? You know, you do get returns which bump around from year to year. That is the nature of business.

THE CHAIRMAN: Can I -- this is leading on to something else, really, which is, now, having done all of that, you have nonetheless gone for the 8.9% which is a 2006 figure.

MR DUCKWORTH: Yes.

THE CHAIRMAN: So I mean, we have had a debate about that and I understand where you are coming from on that. But having then gone into this exercise of comparators and all the rest of it, it just rather strikes me that 8.9% is very, very precise. I mean, if you did not have that starting point, I have no doubt you would be coming up with saying, I do not know, it is 9 or it is 10 or it is 12 or it is 8, or something like that.

So should we be as specific as 8.9? Or to put it another way, if I can put you on the spot, and Mr Parker too, given that there are some uncertainties in all of this, what is, as it were, the upper limit of your exercise which you think is justified on the materials you have got?

MR DUCKWORTH: I would agree that taking a single point estimate from a single year is sort of effectively a degree of false precision, and there is a range, and we should take the evidence in the round. Having done that, I do not think I am that far away from Ofcom's view in 2017.

THE CHAIRMAN: Which was, just remind me?

MR DUCKWORTH: Which was a level of returns consistent with -- I have forgotten the exact form of words, but level of profitability consistent with a competitive outcome, or similar words, in the range of 5-10%.

THE CHAIRMAN: So your upper limit is 10% on that basis.

MR DUCKWORTH: Yes. I think there are obviously some comparators which are slightly higher than that, but most of the comparators are within that range, and if we are looking at trying to establish a sort of an average, then --

THE CHAIRMAN: Yes, and particularly because you do not espouse the percentile approach.

MR DUCKWORTH: Exactly.

THE CHAIRMAN: So at the end of the day, based on your expert evidence, the submission that is going to be made on behalf of the Class Representative is going to be, I would imagine, something along the lines, or on the evidence, that the reasonable rate of return cannot be above some figure, and you are putting that it cannot be above 10%.

MR DUCKWORTH: Yes.

THE CHAIRMAN: Right.

Anything you want to add on that, Mr Parker?

MR PARKER: One factual point. If we go to {E/6/85}. So you were talking about TalkTalk's returns potentially being up to the 16% level. I think that might be the Virgin line?

THE CHAIRMAN: Yes, that is right. I am sorry, it was Virgin, not TalkTalk.

MR PARKER: Yes, TalkTalk is the dark blue line, and that is bumping around between 11% at its high point and maybe 3%, 3%-ish, as its low point, with the average being I think 6.9%.

I think I would agree with Mr Duckworth that if you put -- if you take that, if you take the Post Office figure that is on the next page, if you take Ofcom's view, then around 10% of the upper bound of sort of the most relevant comparators feels to me to be about right. I mean, I agree 8.9 is precise, but you need to put something into your model, and often if you go for a round number people say that that is suspiciously round, so there is no perfect answer. You have to have something to put into the modelling, but it feels to me that the range that Mr Duckworth has described is a reasonable one.

THE CHAIRMAN: Thank you.

Now I want to put the same question to Dr Jenkins. Now, I know that the primary view that you have taken on the basis of the materials is 25%, but did you not put an alternative of 20% in?

DR JENKINS: Yes, that is right.

THE CHAIRMAN: What I want to know from you is how firm that 20% is and whether, in truth, if you were to look at all the materials, you would say: certainly the reasonable rate of return cannot be less than 20%. If that is not your position, what is the purpose of this 20% thing?

DR JENKINS: Yes, I think that is a good way to put it, that the reasonable rate of return for this segment in a workably competitive environment cannot be less than 20%. That was the rate that BT was earning on the Standalone Fixed Voice business in 2009 before bundling was introduced. So on that segment that we have looked at, that Mr Duckworth's cost benchmarks are based on that year's costs, so that 20% was the amount that BT was earning at the time. That 20% is consistent with -- more or less consistent with what BT was earning on Dual Play margins as well. So there are lots of indicators of that 20% as sort of an average -- certainly if you are thinking about an average over a number of years, right.

Then I think my 25% is if you are looking at any one year and you are thinking what -- a price above what level would cause you to say, okay, that is looking really quite high, then that is where the 25% benchmark comes from, to ensure that you are not overly chilling the competitive incentives in any market situation by putting an average constraint as a sort of year-by-year benchmark.

THE CHAIRMAN: Thank you.

Now, the one follow-up on that is you have explained what the difference between the 25% and 20% approach is. But as I understand it, your "not less than 20%" figure is still using your 90th percentile approach?

DR JENKINS: So the 20% figure from the benchmarking that I have done would be consistent with like a 75th percentile.

THE CHAIRMAN: So the percentile has changed.

DR JENKINS: It changes when you get to the lower number, yes. It is not all the way down to the average level, so it is sort of upper mid -- it is third quartile, 75th percentile, and it also cross-checks with the actual outcomes that we see in the market at various points in time.

Because I think one has to be really careful about looking at what actually happened and then saying, well, if it was above what actually happened, by definition it is excessive. I mean, that is based on the predicate that you have already decided there is a problem. It is quite possible that, because of the competition in the market, the observed outcomes are below the excessive benchmark.

It is a difficult question, which is why looking more broadly is the approach I have taken. So the 20% return is the upper quartile of my range and also benchmarks well with the actual evidence we see for SFV services.

THE CHAIRMAN: Is the difference in this respect between the 25% benchmark and the 20% benchmark as a matter of maths just the difference between the 75th percentile and the 90th percentile or is there something else floating around in there?

DR JENKINS: In terms of the maths from the benchmark, the broad benchmarking exercise I have done is the difference between the 75th -- if you think of the distribution, the 75th percentile is at 20%, the 90th is at 25%. As a matter of broader evidence, the 20% also is aligned with other evidence that we see in the market. So you find that benchmark both from upper quartile from the broader benchmarking but also what was actually observed in SFV services in 2009 and also the Dual Play benchmark that Ofcom finds in 2017.

THE CHAIRMAN: Then presumably -- this is the final question I wanted to ask -- if anyone was minded to do the exercise on these or any other figures if that is the 75th percentile your 50th percentile is going to be what? Somebody can tell me presumably.

DR JENKINS: You can --

THE CHAIRMAN: Probably somebody has done it I am sure.

DR JENKINS: Indeed, and that is the sort of 12-15% number that we have been discussing.

THE CHAIRMAN: Yes.

MR RIDYARD: I think I would like to go on now to the question of significance and materiality in excess of any cost-plus benchmark that we might reach under limb 1.

The first question is: what regulatory and policy principles could be relevant to this question of how you go about -- looking at this -- where an excess return is significant or -- significantly above the benchmark.

Who would like to have the first go at that?
Mr Matthew.

MR MATTHEW: Shall I just -- to summarise a number of themes made previously, I do start from this with a view that intervening on prices is a big step for an ex post regime, both because it tends to undermine the pricing incentives and the profit motives that apply in the market concerned and also in those markets to a degree replace market dynamics and market incentives with the shadow of potential regulation and those do tend to be slippery slopes as regulators know, but also because once you set a rule that essentially says, well, if we are going to make the thresholds before we treat high pricing in the normal course of business, potentially illegal and subject to fines, that could have a broad chilling effect because pretty much all firms set prices and if you look hard enough a lot of firms will earn higher margins in some parts of their businesses than others and the risks here to firms that might believe themselves to be potentially dominant are quite high.

So I think that is my general starting point, and that would point to there are a number of issues about how you are going to build up your cost-plus benchmark but if you are going to use those benchmarks you should then have a decent margin on top before you start to say, well, this is something we should be intervening on.

MR RIDYARD: Thank you. Mr Parker.

MR PARKER: I think I have also made my position clear on this in the previous but just reiterating the question there, was clearly you have a benchmark and then it is a question of significance above that. I am not talking, suggesting that any price that leads to a profit above the benchmark would be excessive. It does have to be significant and persistent and both of those things are important. Ultimately significance is a question for the Tribunal so I am not going to give a firm mathematical answer to that. I think there are a range of contextual factors which we will discuss.

On the question of sort of chilling effects and innovation, I think if there is lots of innovation you should be trying to capture both costs and the risks of that in your competitive benchmark, but to the extent that the riskiness of it requires certain return then you should think about that both potentially in the return, if you have measured your -- if we had a CAPM type approach and we could do capital intensity then it would be in your benchmark or should be in your benchmark. If not you might need to make some adjustments. I do not think we are in a market here where that is a particularly relevant consideration and in relation to SFV services.

In relation to chilling effects I think the extent of those will depend on how precisely the case is made specific to the particular market context. The pharma cases clearly had a particular context. I am not aware of a chilling effect on the basis of those decisions causing ripples across the economy. It seems to me there are distinguishing features in this case which make it quite specific around the former work incumbent and legacy product and so on that that already narrows you down to a very small handful of firms and I am not sure why there would be chilling effects more widely.

MR RIDYARD: Can I put that point, Mr Matthew, to you actually because it is an interesting one.

MR MATTHEW: So it is an interesting one. On the pharmaceutical cases, for me you can look at those circumstances and say those very clearly are a special case because they involve essentially manipulation of a procurement regime, that is the way I read it.

In terms of why this is special, it would not apply, the argument that this is essentially a privatised monopoly, that it deserves to be regulated has long since gone from BT Consumer. It was essentially released from its regulatory arrangements in circumstances where competition was both being promoted and was evolving fast and by 2009 had arrived. BT continued to lose share and Ofcom, again in 2013, took a look and did not demur from the position that retail markets were competitive.

So you are talking about a market that for long periods of time has been treated as and was a competitive market, certainly a workably competitive one, and what has happened here is one part of that, once the dust has settled on how well it worked has been picked out by the regulator using ex ante rules and for reasons of particular concern about elderly customers came back in and used its regulatory powers to bring down prices for them which is a very regulatory thing to do. That is what you do when you are a regulator. You have these powers and this is much more normal.

I think if you were to read out from that story and say, well, that should give comfort to the wider economy I think we would have a lot of difficulties because if you look at the essentials of this case we have one, the cost benchmarking is based on a cost allocation model. Two, we have talked a lot about profit benchmarks. They are not straightforward. One additional variation that was not picked up in the previous discussion is obviously those benchmarks in Mr Duckworth's work are all for the whole company. That is the whole platform. Possibly if you looked within those, and I do not know the answer, but I would not be surprised to find that all of those firms have quite large variations in how much profit, and certainly on the gross margin, they are making from different customers and different groups of customers.

So you go to them and say, well, look, the rule is when you are a bit captive suddenly there is a risk of an excessive pricing case could apply quite broadly and for me would open chilling effects.

So I do not think the pharmaceutical cases are comparable. This for me would be the first case where you have a straightforward claim of here is a firm, not even raised its prices dramatically just did not follow down the wholesale input price essentially for what is now quite a small sub-segment of its business being said, "well that is excessive pricing". That is in a situation where that firm has been competing, as acknowledged and indeed created by the regulator, for very long periods of time.

So I think other firms in a similar situation in other parts of the economy which were not privatised monopolies would find it difficult to read a difference in the case.

MR RIDYARD: Mr Duckworth, do you have any ...

MR DUCKWORTH: I defer to Mr Parker on this issue.

MR RIDYARD: Thank you, yes.

Dr Jenkins.

DR JENKINS: Yes, I will not add very much more, except again this distinction between looking at sort of average performance, which in some sense might fit with a dominance assessment. Like when you think about profitability analysis in dominance and you look at, okay, what has happened over time, with what is the benchmark whereby you can say pricing is excessive.

To echo the views of Mr Matthew there, once you set that type of price benchmark, that has very -- potentially very strong precedent features for how businesses then have to think about price setting going forward, as opposed to, well, what was your outturn on average?

So that is why I have advocated that, in thinking about the actual price benchmark, you want to be taking the upper bounds of reasonable ranges as have been observed in conditions of workable competition.

MR RIDYARD: Okay.

THE CHAIRMAN: We do not think we have got too much more, but we will reflect on that over lunch. We will stop now and resume at 2 o'clock.

(12.56 pm)

(Luncheon Adjournment)

(2.00 pm)

MR RIDYARD: Right, we are nearing the end of this particular part of the ordeal! We think a lot of the questions that we were planning to ask have been covered one way or another.

We would like to ask a general question about, still on this question of significance, is there anything to do with the degree of innovation or the way in which customers were acquired which feeds into the question of the way we look at significance that has not already been covered in the discussions so far?

Dr Jenkins, do you want to go first on that? I will accept "No" for an answer.

DR JENKINS: I think the answer is probably "No". We have talked a lot about how you think about dealing with ranges in workable competition, what drives those ranges, and I guess the point we have already discussed is there is a disagreement about the extent of innovatory activity that has occurred in the provision of services to SFV customers, drawn broadly. But I think we have rehearsed a lot of that content already.

MR RIDYARD: Yes.

Mr Parker?

MR PARKER: No, nothing to add.

MR RIDYARD: Great. Okay.

So one thing which we have not talked about explicitly is the fact that the product is a subscription service, rather than a spot market purchase. Does that have any relationship to these questions of significance and materiality?

Mr Parker.

MR PARKER: It seems to me that it does, and I think there is agreement that there is a relationship between significance and persistence, so the longer something persists, maybe the less far above the benchmark you need for it to be significant. I think in that context the fact that it is a subscription product in which, if you are on the product, you are on the product until you make an active decision to leave, perhaps has some relevance, because you will continue to pay those prices.

But more than that, I would not place further weight on it than that.

MR MATTHEW: Just a very brief comment. I do touch on this in my report as well, and the observation is simply if a firm has very substantial market power and can set very high prices, that can happen in a spot market, a subscription market, they are all different ways of setting prices. So I do not see there is something that separates this market out.

MR RIDYARD: What does persistence mean then? We are looking at whether the excessive price is persistent, so what does that mean?

MR MATTHEW: For me, it would be persistence in that ability to serve very high prices. So if we take another firm in -- it is a spot market, so they are selling something which is not through subscription, they just sell fizzy drinks, that is a particularly common position. If you were to evaluate the prices and profitability of that using a cost-plus approach or otherwise, you would want to be looking at its position over a substantial time period, not just a one-off. So similarly to here, you should just be looking at the persistence of the ability to set these excessive prices.

MR RIDYARD: But if we know the average contract length is, just to pluck a number, say eight years, does that make a bit of a difference? Because whatever happens there, on average you are going to be stuck with it for eight years.

MR MATTHEW: I am not -- well, people can always leave their contracts and people do move around from time to time, they do switch providers, and you would also have an overlapping period of the contract, so there is nothing locking them in to that period. So for me it does come back down to that basic point of are you selling high prices for long periods of time?

I do have one exception to that general observation, though. I do -- so there is -- I do touch on this in my report -- one set of circumstances where you might not be looking for very long periods before you say this is not right, would be sort of -- I call them out-of-equilibrium markets. So a situation such as that which arose during the Covid period where the CMA said, well, hand sanitiser prices -- there were worries that they were suddenly going to go up because -- not because someone has built a strong position in the hand sanitisers market that is going to last for long periods of time, just simply it is opportunistic -- potentially viewed as opportunistic price increases in conditions where suddenly everything has changed, and it takes a while.

So you can see that, and you do see that in some of the pharmaceutical cases, actually, where in some cases it was very quickly increasing the prices when you have adopted your strategy.

THE CHAIRMAN: Just following on from that, on the question of persistence, and looking at it purely from the question of economics, if the position were that the

Class Representative could show a price which was significantly above the competitive level, and that was demonstrated -- let us take the claim period for the Voice Only Customers which is three years, and I will go to Dr Jenkins, will you be saying that is not persistent, all those other factors going in their favour?

DR JENKINS: Yes, I think persistence, when it has been considered often in situations around excess profitability it is often tied to investment cycles. Actually, I think that is sort of the definition, which is if you have had to invest upfront in some way, or -- so if you take three, four, five years, but you have taken a segment which did not recognise periods of investment or tail-off or competition, that is what you want to be careful about. So I do not think there is one simple answer to that question.

I think generally five years is certainly seen as persistent; whether three might also be considered persistent? To that extent, it does -- it would be affected by the practices in that market.

THE CHAIRMAN: Yes, I mean, you obviously have a number of rather more fundamental objections to this whole analysis before getting to the sort of final part. But does your report actually deal with this question of if it was too high, etc., etc., it would not be persistent?

DR JENKINS: I do not particularly do that. What I do say is the more significant the gap, the shorter the period for persistence might be, so there is some sort of --

THE CHAIRMAN: Which is what Mr Parker, I think, was saying.

DR JENKINS: Yes, so I agree with Mr Parker on that.

Just on the point on subscription services, I do not think there is anything particularly different about subscription services. I mean, here we have one of the products which was actually an up-front purchase for a 12-month period. I do not think there is any difference of treatment or thinking it is more or less significant because people were paying in a one-year point, or maybe that is still considered subscription. But in the sense of if you pay monthly and you decide to switch, which many of these customers did, who were in the claim period at the beginning of the period, in a sense the fact it is on a monthly basis means that you stop paying it within the month that you decide you want to decide to do something different, which is different from a lump sum type of purchase.

So, for me, I actually put very little weight on the subscription element of that, and thinking that makes it more persistent or less persistent.

MR RIDYARD: I understand that. So maybe if you fold into that assessment the fact that once you are on a subscription there might be a default tendency to stay with it ...

DR JENKINS: I would just think the switching evidence does suggest the bulk of customers -- I mean, if there is that, I think the nature of that subscription element is because of the nature of the service that is being provided. The question of whether or not someone is assessing and engaged in whether or not they feel they are receiving good value for money for that product that they pay is a sort of separate question from whether or not you are being provided a service which naturally makes sense to pay in, you know, whether it is monthly or quarterly or annual elements, which reflects the fact that there is a flow of services being provided here in terms of the ability to make and receive calls.

MR RIDYARD: So a subscription is not an artificial device which has been designed for lock-in, it is just --

DR JENKINS: That is how these services were provided. They are a flow of services to make and receive calls.

MR RIDYARD: Yes.

Any final point on that?

MR PARKER: Yes, on persistency. So I think I would have a slightly different position on not so much settlement cycles, but the speed at which capacity can adjust. So

I think Mr Matthew's example of the sort of Covid shortages of hand sanitiser or wipes, or whatever it was that people were really keen on, masks and that sort of thing, actually what I would draw from that is that that position resolved itself really quickly, and as soon as there was a clear market signal, there was demand, people could order more hand sanitiser and more masks or whatever, and the price went back down to a competitive level within two or three months. I think that is the finding of the CMA when it was asked to look at this.

That seems to me not persistent, and the reason being that capacity adjusted as quickly as capacity could adjust, and then this sort of disequilibrium situation caused by a massive demand shock just worked its way out, because there was an equally large supply shock.

Here, I think the relevant issue is to what extent do you need more capacity, or do you need to make an investment to take on more SFV customers? Because we are talking about SFV customers. It seems to me you do not really need very much there, because you are getting your main input from Openreach and you are sort of reselling that, and then you have your billing system, and so on, and other costs attached. But I am not really sure what these capacity investments are that need to be made.

So if it was a question of there is a short-term issue, BT's prices are too high, other people can come in and compete for that, it seems to me that that should have been doable pretty quickly, looking at the capacity requirements. What was stopping that was the customer acquisition costs and the inertia and the need to overcome that inertia.

For me, I do not really think -- sorry, I think that points to not much capacity investment required to expand, so actually you do not need to be -- it does not need to take that long before you start thinking, oh, this is persistent, because it is beyond -- the prices are persisting beyond the time period that you would naturally expect if it was just about capacity adjustments.

THE CHAIRMAN: Can I just quickly ask: you said, on the relationship between significance and persistence, the longer something persists, it may be the less far above the benchmark you would need for it to be significant. Does the converse apply?

MR PARKER: Yes.

THE CHAIRMAN: Right.

Dr Jenkins, you said that you agreed with Mr Parker, and is that right, you agree with the converse as well?

DR JENKINS: Yes, that is right.

THE CHAIRMAN: That is helpful, thank you.

MR RIDYARD: Just so I am clear about what you are saying about the hand sanitiser thing. Are you saying that although that was a very high price-cost margin, the fact that there was a market mechanism to sort it out pretty quickly within two or three months means -- and even though it caused outrage, it was not an abuse because the supply service response was quick enough.

MR PARKER: Exactly. That was luck. The people who happened to have hand sanitiser in stock at the time that demand went through the roof did very well, but as soon as they were out of stock they had to get more stock. Everyone else wanted more stock. There was no ongoing pricing power, it was just ...

MR RIDYARD: No, no, that is what I thought you said but I just wanted to clarify.

MR MATTHEW: Just to clarify, just in case it was not clear, I am not suggesting there was a problem with hand sanitisers, I was merely offering it as one caveat to the general view that persistence should be a reasonable time period.

MR RIDYARD: So I think then I just have one question left which again might already have been covered. We certainly had -- obviously we have had comments about the importance or otherwise of demonstration effects here, and chilling incentives in the economy at large, but is there anything about the asymmetry, if it exists at all, asymmetry between what you might call type 1 or type 2 areas in this kind of case that would affect the way in which we assess significance and -- the notion of significance and/or materiality in the abuse? Should that in itself, in a way in which we have not already covered in the other discussions about chilling effects, affect the way in which we look at significance?

Dr Jenkins.

DR JENKINS: So I think this will be a matter for the Tribunal, but I think from the economics perspective, and I hope I get this the right way round, I think it is worse to falsely find an excessive price where it does not exist, which I think is type 1, than type 2, which is to allow an excessive price to continue when it should not. The reason -- and particularly in a situation where there are active alternatives available to the customers, if they choose to take it, because of the sort of more general risks that you see in terms of capping off potential -- the top end of a distribution, which the type 1 error will do. It has this -- it can have this ripple effect that we have discussed.

That is for the Tribunal to decide about that, but obviously that compliance or the ex-ante impact on pricing of truncating the return, the distribution of returns too early can have the very big impact across the economy. Whereas making the error the other way round will affect -- it may affect a certain set of customers who are paying a certain price for a certain product. So you do have to weigh up in that situation with those customers.

It perhaps goes to some of the limb 2 considerations about were they -- did they have options? Could they have availed themselves of options? Did they feel satisfied with what they were getting? If you are in a situation where none of those are true, you may wish to ensure that you were not allowing that kind of unfairness to persist. But I think that is a difficult balance to be made.

MR RIDYARD: Mr Parker.

MR PARKER: I think the concept of the type 1 error here is accounted for by the significant and persistent test. So the significant bit particularly is saying you need to be a significant rate above your benchmark, and that is because I think of a need to avoid those type 1 errors. So I think that is how the law is kind of treating type 1 errors in this case.

MR RIDYARD: Thank you.

Right, I think that covers all of our ground on this. Thank you very much.

THE CHAIRMAN: Thank you. Now, strictly speaking, as we have come to the end of this hot tub session, there is the opportunity for counsel to ask clarificatory questions if they wish, otherwise we will be -- which will form part of this session, before we will take a break and allow things to be moved around for cross-examination as such.

So ...

MS KREISBERGER: I do not have any.

THE CHAIRMAN: Right. Mr Beard?

MR BEARD: Yes, I do, I have a couple, because I think they are questions that may be more usefully directed to all four than just pointed for cross-examination, if that is okay.

THE CHAIRMAN: Of course.

Questions by MR BEARD

MR BEARD: I will just tell you the four things I was going to touch on. One was a couple of clarifications in relation to sports issues that have come up, one was in relation to VULA issues, one was in relation to TSO, and one was in relation to price dispersion. Some of these are points where some of the experts have referred to matters, and I am just going back to what I think are documents they have referred to. Others are just exposition, but allowing the exposition to be open rather than just a matter of cross-examination.

So if I start with the first of them, which was about sport. This actually goes back to something Mr Matthew referred to where he talked about Ofcom's consideration of sport in the context of the VULA margin case.

We did not -- we were not fast enough with our references to be able to pass them up at the time, but if we could go to {F/782/1}. This is the annexes to the "Fixed Access Market Reviews: Approach to the VULA margin". I will come back to VULA in relation to the second topic more generally.

If we could just go over the page {F/782/2}, you will see there is a series of annexes and the first of those is "BT's strategy in relation to sport".

Can we just go down to the start of that {F/782/3}. Here we see, this is an Ofcom document obviously:

"... summarise the evidence on BT's motivation for investing in BT Sport."

Which I think is what Mr Matthew was referring to, because it talks about the finding that:

"This shows that this investment was to support its broadband business and, in particular, to increase customer acquisition and retention on superfast broadband packages."

First of all, I wanted to check that was what Mr Matthew was referring to, and then obviously provide an opportunity for the experts to comment on it.

MR MATTHEW: Yes, so this annex is one of the sources that highlights exactly the issue I was referring to, which is that in the VULA margin regulation Ofcom deliberated on whether or not to include sports rights as part of the BT retail margin for superfast broadband services, and decided you should, precisely because it concluded that the sports business was being developed in large part with driving the broadband business forwards. So it was right to include those costs.

THE CHAIRMAN: Yes.

MR BEARD: Next clarification. This one I think is more directed for Mr Parker, and I thought it was easier to pick up now than try and fiddle around in cross-examination. It is {E/49/262}. Again, this is sport related. I think this is something where -- Mr Parker on the transcript was referring to "BT Sport on a standalone basis", and referring to the bottom row figures on that table.

But I am guessing, Mr Parker, that you are not qualifying the interpretation of the line which is "Proportion of BT Sport lines sold in bundles including fixed voice". In other words, the fall is not -- to put it openly -- not necessarily if there were any standalone, but it is sport in bundles where there is not voice. Is that how you read that table?

MR PARKER: Yes, so I think two things. I think -- in the discussion I think we had a clarification that the way to read this would be in 2015/16, 93% of BT Sport lines are sold in bundles including fixed voice, meaning 77% were not, and I think we did get that clarification.

In terms of the observation "sold in bundles including fixed voice", I think we saw, possibly last week, the vast majority of bundles do include a fixed voice element.

Towards the end of the period in the last couple of years that is less the case. There might have been a little bit of -- a slightly different interpretation perhaps around the end, but by and large the bundles that were being sold during this period were -- the majority included fixed voice. So I think it gives you the same sort of picture.

MR BEARD: Right. I am not going to pursue that further, I just wanted to make sure we were clear on what was being said there.

Then there is one that I just wanted to ask both of Mr Duckworth and Mr Parker. It is {F/846/1}. This is a 2011 document and I just wanted to ask either of them whether they had looked at this document prior to the preparation of any of their reports, or if they recall doing so?

MR PARKER: I do not recall.

MR DUCKWORTH: I do not recall either.

MR BEARD: Can I just go to page {F/846/12}, just to double check. Do you recall seeing ... next page, I am so sorry {F/846/13}. No; and again, I am sorry {F/846/14}. It was one particular ... sorry, keep going {F/846/18}.

That does not ring any bells?

MR PARKER: No.

MR DUCKWORTH: No.

MR BEARD: No. Thank you.

Okay, that was the clarifications I had in relation to sport.

THE CHAIRMAN: Yes.

MR BEARD: Just VULA. It has been mentioned a few times in answers, I mean, it is really a matter for the Tribunal, but {F/783/1}. This is the statement on Fixed Access Market Reviews. It has been referred to sort of tangentially. I did not know whether it was useful for the Tribunal to have the outline views of the experts in

relation to the significance or otherwise of this, or
whether you feel that the questions you have asked cover
that?

MR RIDYARD: (inaudible) It took me by surprise. I am not
sure, to be honest.

THE CHAIRMAN: I think the answer is we have certainly had
some reference to this. I think maybe Mr Matthew made
some reference to it. But I think, as you have raised
it, Mr Beard, if there is something that the experts
specifically want to say about this document, insofar as
it is relevant, then let us do so. Let us just go
across.

Mr Parker.

MR PARKER: I think Mr Duckworth -- it is more in his area.

THE CHAIRMAN: Yes. If not, fine.

MR DUCKWORTH: I was involved for a respondent to this
consultation process and also involved in the appeal of
the decision in front of the CAT, so I will say that,
which then makes it difficult for me to know where to
start, because I am not sure what aspect ...

THE CHAIRMAN: Is this something that you have taken into
account -- this is all about margin, I think, but is
this something you have taken into account in your
reports?

MR DUCKWORTH: I have. I do make reference to it, particularly with respect to -- so within this decision there are some determinations on the appropriate attribution of costs to ...

THE CHAIRMAN: That is what it was, yes.

MR DUCKWORTH: Retail costs are similar to the costs of interest here. Attributions of retail cost to the retail products which depend on the wholesale VULA product, and I think I said in my testimony that was on a kind of a LRIC+ basis.

So as Dr Jenkins refers to, there are some discussions of the degree to which costs are fixed and common and costs are variable within the statement, but in the end, because it is a LRIC+ or fully allocated cost methodology, those decisions on what costs are fixed and common are not determinative of how the costs are allocated. It may be -- I think the discussion kind of leads on to what cost drivers to use to allocate those costs, rather than saying, we will try and separately identify those fixed and common costs and, for example, you use a distributed SAC or a SAC combinatorial method.

THE CHAIRMAN: This is an example of somewhere where Ofcom has made some kind of allocation?

MR DUCKWORTH: Yes.

THE CHAIRMAN: Right, thank you.

Dr Jenkins, anything you want to add?

DR JENKINS: Yes, so just building on Mr Duckworth's comments there. Where I relied on the VULA margin analysis is indeed with respect to the information it sheds light with on with how to think about the SG&A categories in my Annex 7 that we discussed.

Now, Ofcom did not separately allocate incremental and common and did not then do causal links for the incremental and some alternative way of allocating common, which is the approach I sought to take.

But what it did do was in doing a fully allocated cost approach, it did think about many of those categories of the SG&A and hence, when I was determining my views on whether to say this has a lower amount of common cost or no common cost or medium to high, I was informed by the approach that Ofcom took in this VULA margin for some of those categories and in particular, my cross-check which relates to TSO costs was judged in this investigation by Ofcom to be one of the categories that was clearly fixed and common.

THE CHAIRMAN: Thank you. Just a moment. (Pause).

Mr Matthew, anything you want to add?

MR MATTHEW: Just to clarify in the same vein as Mr Duckworth, that I was -- I worked on this as well. I was the economics director at Ofcom through the stage of the final phases of developing a decision on the VULA margin and also into the very extensive appeals into that decision that subsequently followed, one before this Tribunal, one went to the CMA. The principal thing I recall from it and that I emphasise is the biggest issue was the treatment of BT Sports' costs and after much deliberation the decision was they should be treated very much as a call part of the broadband business and that it is right to include them in the VULA margin, as Ofcom did.

THE CHAIRMAN: Thank you. I think that has probably covered that, Mr Beard.

MR BEARD: Yes, I think so. The only thing in relation to it, {E/49/133} which is where -- this is the joint expert report picking up on these issues that Dr Jenkins just referred to. There is the TSO and there is reference there, you can see the two positions of Dr Jenkins and Mr Duckworth, but there is reference to a superfast broadband pricing case on page {E/49/134}. That is at {C/343/1}. I do not know if there is anything that is usefully conveyed to the Tribunal about that from the experts.

THE CHAIRMAN: I will do the same thing again. Mr Parker?

MR PARKER: No, not familiar with that I do not think. Just one comment on the VULA margin is obviously that was focusing on the fibre portfolio so within, as Mr Matthew said, was in sort of the scope of what VULA, the service that VULA was providing which was sort of outside of SFV services, so that is the focus of that document.

Otherwise no.

THE CHAIRMAN: Thank you. Mr Duckworth.

MR DUCKWORTH: I did not refer to that decision in my ...

THE CHAIRMAN: No, all right. Dr Jenkins.

DR JENKINS: Perhaps if we just go to {C/343/179}. If we go down to paragraph A2.17. So this is -- you sort of have to read a bit more broadly around here, but this is echoing the finding, building on what Ofcom had done in the VULA case, so the second sentence of paragraph A2.17 I rely on this in my TSO cross-check. So it says:

"The main category of costs which we have treated as fixed and common [which is the TSO fixed costs] are those which would be expected to remain invariant if BT were no longer to have the BT Consumer business."

That is the basis on which I felt that that is a useful cross-check for the Tribunal because in terms of identifying the common costs for BT Consumer.

THE CHAIRMAN: Thank you.

MR MATTHEW: Just again by way of disclosure I was the economics director on this investigation in its latter stages but I have not re-reviewed it in any depth and

I do not recall too much about it beyond again the question of how to treat BT Sport whilst present at the time.

THE CHAIRMAN: Thank you.

MR BEARD: Last one. This goes back a couple of days. There were discussions about price dispersion and how you might see price dispersion and I think there were references to documents which might illustrate price dispersion. Again, I do not think we were fast enough passing references up but could we go to {C/383/20}, please. Sorry, perhaps page {C/383/1} just so we can see which document this is. This is an Ofcom document: pricing trends for communications services and it is 2020.

If we jump forward to page {C/383/20} and just at the focus in on the table there. There was a discussion about price dispersion in relation to broadband as a workably competitive market. I think it was actually raised by Mr Matthew, but can you just articulate what we are seeing there if this is one of the diagrams you had in mind.

MR MATTHEW: Yes, it is this sort of diagram that I had in mind. I cannot recall if it was specifically this one but, yes, this is a plot of the quite diversion range of superfast broadband offers that you get from three of the main suppliers. My observation is simply it is quite broad and that is consistent with my general view and understanding that in retail telecoms markets you just do get quite a lot of price dispersion.

THE CHAIRMAN: I think we have been over the notion of price dispersion in the competitive market.

MR BEARD: Yes, I will not --

MR PARKER: Could we maybe just go to the paragraph before.

MR BEARD: Of course.

MR PARKER: So you will see the second sentence the first paragraph:

"Several factors determined the price paid, including the broadband connection bandwidth, inclusive call allowance, inclusive data allowance and add-ons ..."

And so on. So, yes, there is price dispersion, but that is because some of the features of the products are different.

MR BEARD: Sorry, I was not suggesting otherwise.

THE CHAIRMAN: Right, good. Thank you. Then that has completed that. The experts will be released before they are re-sworn. We will take a slightly longer break now because we will make this our break for today's salient data. We will take 15 minutes and that will allow things to be moved around. Thank you.

MR BEARD: Yes, thank you.
(2.37 pm)
(A short break)
(2.50 pm)
MR BEARD: Given that we are dealing with things in the context of a hot tub, I have said to Ms Kreisberger that whoever she wants us to call first I will do that, and she has agreed that she will call Mr Duckworth first for the purposes of cross-examination. Because of course normally it would be up to the party calling, but since we are in this residual territory, we have agreed that is the more sensible way of dealing with things, and obviously we are dealing with it on the basis that this is not a full cross-examination, as we know.
THE CHAIRMAN: Sure.
MR BEARD: So I will sit down and leave Ms Kreisberger to call Mr Duckworth to be sworn, but I do not think we need to go through the reports.
THE CHAIRMAN: Correct. Thank you.
MS KREISBERGER: So if we could have Mr Duckworth.
MR MARTIN DUCKWORTH (affirmed)
THE CHAIRMAN: Thank you.
Yes, Mr Beard.
Cross-examination by MR BEARD
MR BEARD: Good afternoon, Mr Duckworth. I am sure it is

a prospect you will be looking forward to at ten past 4(sic). I do want to go through some bits of the 2009 RFS and some of the materials in that. I am sure we are all looking forward to that.

Before I do, I just wanted to ask one or two questions about the methodology that you had followed. So could we have your first report, so this is {E/6}, and I just wanted to pick up at paragraph 5.5, if I may.

Mr Duckworth, there are a pile of files in front of you. I think they are just the ones that were before you previously.

A. Yes.

Q. I am not actually sure what is in them, but do feel free to use them if you know what is in them, otherwise I will just call stuff up on the electronic screen. Obviously if some of the documents you want to flick backwards and forwards, do say.

A. Sure.

Q. Could we go to {E/6/44}, please. I just want to pick it up in "Methodology". This is in your section on the competitive benchmark. You say:

"The calculation of a cost-plus competitive benchmark involves the measurement of 'the costs actually incurred' or 'reasonably attributable' to the product in question (in this case, SFV Services and/or

SFV access)."

You have quoted those two phrases. The first one you have put a footnote to *United Brands*, paragraph 252, which I think we are all cryingly familiar with, but {G/107/74}. If we could go down to the bottom of the page. So this is the paragraph you cite:

"The question therefore to be determined is whether the difference between the costs actually incurred and the price actually charge is excessive and, if the answer to this question is in the affirmative, to consider whether a price has been imposed which is either unfair in itself or when compared to competing products."

So it is actual costs, actual prices, which is what you say there.

The other quote you have is from *Albion Water II*, and that is {G/47/10}, I think. So this is paragraph 20 at the bottom of the page. So again, this is the basis on which you say we need to look at "the costs actually incurred", that that is the relevant test, correct?

A. Yes.

Q. Then you say "reasonably attributable", and there you cited *Albion Water* at paragraph 198. So {G/47/65}, so same document. If we just go down to paragraph 198, you see a table of cost assessments just above, and it says:

"Even allowing for the unavoidable uncertainties in the costs calculation, there is a clear disparity between the First Access Price and the cost of the services to be supplied (at a reasonable profit)."

I am not going to go through the details of *Albion Water*, but it was to do with a carriage dispute in relation to water. You understand that?

A. Yes.

Q. Then:

"We therefore find that the First Access Price exceeds the cost reasonably attributable to the service of the transportation and partial treatment of non-potable water by Dwr Cymru, generally and through the Ashgrove system in particular."

So it is that reference to "reasonably attributable" that you are using in your methodology, correct?

A. Yes.

Q. But you understand, do you not, that the language of "reasonably attributable" is reasonable attribution of actual costs there, do you not, Mr Duckworth?

A. I would say that in any costing exercise there is always a degree of estimation, and so ...

Q. Agreed?

A. So --

Q. There will always be a degree of estimation, but it is

actual costs being reasonably attributable here, is it not, Mr Duckworth?
A. It is an estimate of those actual costs, yes.
Q. It is an estimate of the actual costs.
We can see that if we go back to paragraph 40, which is on page 16. {G/47/16}.
You see at the bottom:
"In its Report, the Authority first sought to identify the services Albion reasonably required in 2000/01 ... for its common carriage proposal. Only those services required for common carriage on the Ashgrove system were included as costs that could be defined as 'reasonably attributable' ..."
So the citation you have used for "reasonably attributable" is reasonable attribution of actual costs, you understand that, Mr Duckworth?
A. So I would interpret it as, you know, "only those services required for common carriage on the Ashgrove system" to mean that you would exclude those costs, which were neither incremental nor fixed and common to the provision of these particular services.
Q. That is fine, I am not worried about those categories at the moment, it is the actual costs element that I am focused on. You understand that the citation you have given is to reasonable attribution of actual costs?

A. Yes.
Q. Then I think you have been clear, throughout the last two and a half-odd days, that in your analysis you do not refer to or rely upon any actual costs incurred in the claim period in relation to indirect or common costs, do you, Mr Duckworth?
A. I have considered the availability of information on actual, as you have put it, costs incurred during this time period, and the degree of granularity that is available, and I have made a reasonable -- a reasoned decision that the appropriate way to estimate the actual costs incurred is not to take BT's high level management accounts and attribute them, but instead to project forwards from another cost base.
Q. Let me just ask the question again. You do not refer to or rely upon any actual costs incurred in the claim period in relation to indirect or common costs in your methodology, do you, Mr Duckworth?
A. No, I do not.
Q. No. More than that, you take your 2009 RFS methodology and you do not try and map it on to the actual costs incurred at all, do you?
A. Because that would be impossible.
Q. You do not seek to make any cross-check or reference to actual costs in relation to your methodology, do you,

Mr Duckworth?
A. I did review the actual costs. I did review the available data in great depth when making the judgment that the appropriate way to estimate the costs actually incurred in the period was to project forwards from the 2009 RFS.
Q. Just to ask the question again: you do not seek to make any cross-check or reference to actual costs in relation to your methodology, do you, Mr Duckworth?
A. No, because I do not think the actual costs are informative.
Q. Yesterday, I think it was, in the course of your observations you said there might be ways of making modifications to your methodology, and you could tinker with it in certain ways by reference to cost changes or actual costs, but you have not done any of that, have you, Mr Duckworth?
A. So what I suggested was that I consider my approach of indexing with CPI is a conservative method. I was suggesting to the Tribunal that an alternative method would be to look at certain parameters, and I think we talked about one cost which could be identified, which was the onshoring cost, and include that if we could find a kind of robust estimate of the change over time, and then look at the other factors separately, such as

expected cost efficiency, any other quality changes, and apply that, yes.

Q. Let us just take those in turn. Just to be clear, you did not seek to identify any of the costs of the onshoring and take those into consideration, did you?

A. I did not look at that single quality change and incorporate that into my methodology, because I took a more high level approach, yes.

Q. Yes, so you suggested that could have been done but you did not do that.

Then in relation to the efficiencies that you are referring to, you did not explore that in any way, did you?

A. I looked at the costs of -- BT's cost -- sorry, the cost savings reported by BT Consumer in its cost transformation programmes. I looked at the appendix to Mr Cackett's witness statement which also showed reductions in cost on a year-on-year basis of the order of around 5% per year.

Q. Right. Just on that, I have got Mr Cackett's witness statement and there is not actually an appendix to it. Are you referring to the medium term plan that he referred to in the course of cross-examination?

A. Yes, I think that was annexed to his ...

Q. Right, yes. So that was a medium term plan from 2020,

is that right?
A. Yes, that is right.
Q. It is a five-year plan?
A. Yes.
Q. Do you know whether those efficiencies that were forecast there were actually achieved?
A. As I say, I have not done an explicit forecast of efficiency gains. I am using that as being informative that BT expects to make significant efficiency gains over time.
Q. Is it "expect" or "hope", Mr Duckworth?
A. Well, there is the factual evidence on the cost transformation where it does actually make efficiency gains. You know, medium term plans I assume are not just purely aspirational and have some sort of --
Q. Yes. I think Mr Cackett gave very clear evidence that they are real plans --
A. Yes.
Q. -- and they are often not hit?
A. That is true.
Q. Yes. So you said "onshoring efficiencies and quality changes", I think you referred to. Now, we have had an awful lot of evidence about the importance for BT in promoting its products and competing on quality, what it often refers to as "gives". But you did not try and

take any of that material into account in your methodology, did you?
A. I did, because a number of those gives are within the direct costs, and so they are included. So the Care Level 2 costs, for example, were included in cost of sales, and I have included that in my methodology. Some of the Call Protect features were also included in my methodology, yes.
Q. In the direct costs element, I am sorry. You are quite right to pick me up, Mr Duckworth.
Insofar as any of those gives might amount to common costs or indirect costs, you do not consider those, do you?
A. No.
Q. I think those were the three that you referred to.
Let us go to the 2009 RFS {E/13/731}.
I am very sorry for the operator of the EP, but each time I think you are going to have to rotate these pages.
EPE OPERATOR: Yes. I also think it is two pages out.
MR BEARD: Thank you.
Okay, so here we have -- I think we agree this is the 2009 RFS. This is taken from the bundle of documents you served with your first report? {E/13/733}
A. Yes.

Q. So if we go over two pages {E/13/735}, here we see the introduction to the RFS, and I am sure you are familiar with this, Mr Duckworth, yes?
A. Yes.
Q. We see at the top there:
"The purpose of this Statement is to allow Ofcom to comment on the data in, the notes to, or the presentation of, any or all of the Regulatory Financial Statements and/or the Accounting Documents prepared and published by BT ..."
It refers to an "SMP Condition", yes?
A. Yes.
Q. Then it talks about:
"Relevant, reliable and timely regulatory financial information is a vital source of evidence for us ..."
Then it talks about three roles for it:
"Ensuring BT complies with certain conditions placed on it ... where BT has significant market power."
So that is compliance with SMP conditions, yes?
A. Yes.
Q. The next is:
"Providing an important source of financial data for disputes and investigations ..."
This is because you can have disputes between telecoms operators as to what, for instance, BT is doing

and how it might be pricing, and this material might be useful for those purposes, correct?
A. Yes, I think there was a dispute resolution mechanism in some of the SMP conditions, yes.
Q. You are quite right. There was, Mr Duckworth, that is exactly right. It was a dispute resolution mechanism that was used on various occasions and resulted in certain appeals to this Tribunal.
Then the third is:
"Setting and monitoring price controls."
So it is being used for a range of regulatory functions, you agree?
A. It also says "investigations of alleged anti-competitive practices", which is obviously ex post --
Q. Yes, that is completely true, too.
Then we have got some discussion of "Improvements to BT's Current Cost Financial Statements", I am not going to go through that. "Maintaining the current reporting obligations".
Then it says:
"A fundamental review of the reporting framework.
"The basic structure of the current reporting framework was designed over 12 years ago for a different regulatory environment. Over time we have seen significant changes in communication technologies, the

development of new communication services, and a more competitive communication's market landscape. Over this time the regulatory reporting obligations have become more detailed and complex as the regulatory obligations on BT have evolved.

"Given these changes we think it is timely to undertake a fundamental review of the regulatory reporting framework to ensure it remains fit for purpose, provides good quality data and is an effective system for monitoring compliance. Our consultation process will take the opportunity to discuss different potential approaches that could meet our future regulatory requirements."

So in 2009, Ofcom were talking about consulting on changing the way in which Regulatory Financial Statements would be required to be provided by BT. They are talking about that here, correct?

A. Yes.

Q. Just to be clear, they did not immediately start consulting on that process, it took a little while, is that right? Do you know? If it is not something you know about, Mr Duckworth, it does not matter.

A. I mean, I am aware -- because I reviewed material -- that Ofcom consulted on an annual basis on incremental changes to the RFS, but this seems to be a more fundamental review that they were --

Q. It was, and I am not intending -- I do not think I need to take you to it, given that you indicate that you have not looked at that. It was a process of extensive consultation.

Obviously in 2009 we also know that the requirement to provide Regulatory Financial Statements in relation to retail markets fell away, and therefore, for our purposes, it may be less important. But the important thing here is at this time those obligations had not fallen away, but Ofcom is very much alive to the need to carry out a full review of how these things are done. Do you see that there?

A. I see reflecting changes in the way services were delivered. So, for example, there was a kind of creation of Openreach in 2005 and commitments. Then that -- and we have had sort of extensive discussion about the changes in the marketplace, the local loop unbundling and the provision of an effective Wholesale Line Rental product created in the market.

I am not sure this is responding to changes in how voice services or retail voice services were delivered, particularly given that, as you say, the requirement to deliver those voice services or to report on the profitability of those voice services had fallen away, so ...

Q. But it had not fallen away now, had it, Mr Duckworth?

A. In 2009 ...

Q. Sorry, this is not a trick question, Mr Duckworth. I can take you forward to where this is considered.

So if we go forward to {E/13/745}, I think. I am not trying to test your memory of dates back in 2009. That would be a particular cruelty.

But that is not it. Try {E/13/751}, I apologise. No, I am sorry, we are too far up. Let us go back to {E/13/741}, if we may. If we could go back one page from there, thank you. I am so sorry {E/13/740}.

If you look at the bottom right-hand side, third paragraph up:

"Ofcom is in the process of consulting on SMP designations in the retail narrowband services markets. Its review relates in particular to the supply of consumer and business telephone lines and ... calls. In the course of this review, Ofcom has proposed that BT no longer has SMP in these markets and that if Ofcom finalises its proposals, this would result in BT having greater freedom to package and price those services as BT chooses."

So that was the 2009 review. Do you see that, Mr Duckworth?

A. Yes. So to just understand, Ofcom is saying in this document BT still has SMP in the retail voice market. On a forward-looking basis it is considering undertaking a review. At the same time, Ofcom is consulting on withdrawing regulation of retail voice, and presumably, as it is thinking about a review in the future, it is also thinking that it is potentially, not definitively, withdrawing those regulations. So I think that is all the --

Q. It is obviously conscious of these things, this is what BT is saying. But the point I am making is we see in paragraphs 9 and 10, back on {E/13/735}, that it is talking more generally about the fact that the regulatory financial reporting framework has been in place for 12 years. Things have changed fundamentally and it needs to review that whole reporting framework. You understand that?

A. Yes.

Q. I am conscious of time. I am just going to refer to one point, because you have actually just picked it up.

So if we go back to -- go on to {E/13/742}, I think it will be. You will see there "Section 1.2 - Regulatory Financial Reporting Obligations". You referred to the fact that there were changes each year in the regulatory financial obligations, and you will see, on the top right-hand side corner, you will see a series of painfully lengthy, but, you will be pleased to know, documents that we do not need to go to -- sorry, top left-hand side.

So you will see:

"The relevant Ofcom documentation --"

Sorry:

"The prescribed form and content of the published ... Financial Statements is reviewed regularly by Ofcom, in the light of changes in the regulatory regime and the needs of stakeholders. The relevant Ofcom documentation is listed below ..."

What you will see there is every year there is a substantial document that looks at and imposes changes on the regulatory financial reporting obligations. That was what you were referring to, was it not, Mr Duckworth?

A. Yes, that is right.

Q. Thank you.

I am going to move on to various points to do with the attribution and allocation. I think that may well be a point that we pause until 9.30 tomorrow morning?

THE CHAIRMAN: It is 3.30. I appreciate that time flies, but not that fast!

MR BEARD: Then I am very happy. Let us go on Two Pages,

three pages. "Statement of Responsibility" {E/13/745}.
Here we have the statement of responsibility:

"BT Group ... is required to prepare Current Cost Financial Statements ..."

You will see they include some comparative information:

"The Current Cost Financial Statements are prepared in accordance with the Primary Accounting Documents and Secondary Accounting Documents (namely the Detailed Attribution Methods ..."

So that is what gets referred to as the DAM, is it not, Mr Duckworth?

A. Yes, that is right.

Q. Then:

"... the Detailed Valuation Methodology and the Long Run Incremental Cost Model: Relationships and Parameters). Insofar as there is any inconsistency in the Primary and Secondary Accounting Documents, BT ensures that the Current Cost Financial Statements are prepared in accordance with the Primary Accounting Documents in the following order of priority ..."

Then we have the Regulatory Accounting Principles, the Attribution Methods, the Transfer Charging System, the Accounting Policies, and then the Long Run Incremental Cost Methodology. So those are five key documents, the primary documents. You understand that?

A. Yes.

Q. Then:

"The Current Cost Financial Statements are reconciled to the BT Group's Annual Report and that reconciliation is demonstrated and explained."

So this is a sort of phraseology and structure that we see rather repeated in numerous documents, but I am just taking you to it here for the first time, and I will not go back through it on numerous occasions.

If we could then go to {E/13/751}. This is section 4, the "Basis of Preparation". If we just pick it up on the top left-hand side. So if we can just blow it up because it is quite small. You see there is a description of BT Group, and then:

"BT's Current Cost Financial Statements are not statutory accounts within the meaning of the Companies Act 1985. The company has, by agreement with BT Group ... prepared the Current Cost Financial Statements in accordance with the Accounting Documents, by disaggregating balances recorded in the general ledgers ..."

Then you will see, if you go down the page, we will then see those documents that we have seen previously reappearing, if we just move down, setting out the primary accounting documents, and that is just spelling them out in slightly more detail.

Then if we go across the page to the top left-hand side -- the top right-hand side:

"The economic Markets defined by Ofcom's Final Statements and Notifications do not correspond to the way in which the Group is organised for management and accounting purposes. The Current Cost Financial Statements are therefore produced by overlaying the requirements of the regulatory reporting framework on the management and accounting structure ..."

So this is the process of taking the actual commercial management material which is being outlined here and turning it into the regulatory financial statement. You understand that, Mr Duckworth?

A. Yes.

Q. Yes. Then it says:

"As far as possible, revenues, costs, assets and liabilities are directly associated with a product group or component using information held within the Group's accounting records and are directly attributed to that item. Where no such direct association is possible, the remaining revenues, costs, assets and liabilities are apportioned between two or more markets, services or components using a fully allocated accounting system and employing apportionment bases that reflect as far as possible the causality of the revenue, cost, asset or liability."

This is what I think you have referred to, and the chairman picked up, as the cost causality principle being applied as far as possible, correct?

A. Yes.

Q. Then it says:

"The amounts of revenue, cost and capital employed attributed to markets, services and components depend critically on the methods of attribution adopted. Typically, in a fully allocated accounting system, a range of attribution methods is available."

You accept that, do you not, Mr Duckworth?

A. Yes, I mean, what it is saying here, if you read the next sentence --

Q. Sorry, I was going to come on -- I am happy to, yes:

"In selecting appropriate attribution methods and appropriate non-financial data for use within the attribution models employed in the production of these Current Cost Financial Statements, BT has had to make certain estimates and exercise its judgment, having regard to the regulatory accounting principles, including cost causality and objectivity, in order to comply with the requirements of the primary accounting documents."

It says here:

"BT seeks to review and update non-financial data used within the attribution models at least annually."

So let me ask the question in the context of that. You accept, I think, that there is a range of attribution models available to be used here, correct?

A. I would interpret this as saying BT has a range of attribution methodologies available to it and it picks the appropriate one, based on the information it has got, in order to follow the regulatory accounting principles.

So it is not just an arbitrary selection, it is a selection which reflects the regulatory accounting principles.

Q. Certainly it has to take into account the regulatory accounting principles, but it says:

"... BT has had to make certain estimates and exercise its judgment ..."

You do not dispute that in relation to these methodologies at all?

A. No.

Q. Now, I am not going to take you through more of this document because I want to move on to the next one, but we know from the remainder of this document that effectively this is the source of the material that we actually see summarised in Dr Jenkins' Figure 5.4. So that is {E/18/131}.

I know that you do not agree with the interpretation that Dr Jenkins draws from this, but these figures, 2008/09, 2007/08, 2006/07, you do not actually disagree with any of the figures. They are all drawn from the financial regulatory statements. That is correct, is it not, Mr Duckworth?

A. That is correct. In some cases you may actually get slightly different figures for the same year, because each financial regulatory statement reports the current year and the previous year and sometimes there are revisions in the previous year but broadly these are taken from.

Q. I understand there are revisions, yes. I think we may come back to that. The next document I want to go to is the regulatory accounting principles, so that was the first of the primary accounting documents that we saw. It is 13 August 2009 version. So that is {E/13/873}. You are familiar with this, I am sure?

A. Yes.

Q. If we go on to {E/13/895}, you will see there, there is a list of Regulatory Accounting Principles, and I anticipate this is what the chairman may have been looking at at some point in reviewing these materials because it has Principle 1, consideration of priority, so which principles take which order; Principle 2, in relation to definitions; then Principle 3 is the cost causality principle that we have already bumped into:

"Revenue (including appropriate transfer charges), costs (including appropriate transfer charges), assets and liabilities shall be attributed to network components, wholesale services and retail products in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred.

"Where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the preceding paragraph, the attribution shall be such as to present fairly the revenues, costs, assets and liabilities accounted for in the Regulatory Financial Statement for each SMP Market or Technical Area (as applicable), as disaggregated, where BT has a regulatory financial reporting obligation and to present fairly a comparison between the Markets or Technical Areas ... as disaggregated."

So that is capturing the causality principle a little more fully, correct, Mr Duckworth?

A. It is capturing both the cost causality principle but also the principle that costs which cannot be attributable based on cost causality should be, as it says here, presented fairly.

Q. Entirely understood. Entirely understood.

If we go on then over the page, {E/13/896} we hit the section on attribution methods.

A. Can we go ... so I can just read.

Q. {E/13/897}, I am so sorry. Top of the page. Yes.

So you just see at the top there it is a summary referring again to the requirements on BT, referring again to some of the underlying documents.

A. Can we scroll down?

Q. Yes, of course. I am actually going to take you to the bit slightly below the bullet points, but feel free. I want to go to the bit which says "Attribution methodologies are regularly ..."

So:

"Attribution methodologies are regularly reviewed and enhancements introduced to reflect, for example, changing technologies while the apportionment bases, which are the practical application of these methods to actual values, are updated at least annually. A BT process has been established to validate all attribution methods to achieve objective bases."

So what is being said here is we have seen from the cost causality principle, and the attribution point that is seen as part of it that you refer to, that there are a range of methodologies that can be used. What is being said here is that those are regularly reviewed at least annually, and it is referred to as "enhancements", but those are changes to the methodologies that can be introduced annually. That is correct, is it not?

A. It says, sorry, "the apportionment bases ... are updated at least annually". So that is the sort of, for example, the operating data used for a cost attribution, say, for example, activity based costing, timesheets.

It says:

"Attribution methodologies are regularly reviewed ..."

But it does not say annually.

It says:

"... enhancements introduced to reflect, for example, changing technologies while the apportionment bases ..."

So the underlying data, is updated annually.

So there is a distinction there. It is not the cost attribution methodologies --

Q. Do methodologies necessarily need to be updated annually?

A. Not even that they are -- it says they are "regularly reviewed". It does not say they are reviewed every year.

Q. We have already seen, have we not, the list of Ofcom documents that each year set out that there were changed methodologies, did we not?

A. So the Ofcom documents do not generally specify the methodology that BT must use in the RFS. The Ofcom documents say what the output of the RFS should be. So, for example, if there is a change in SMP conditions then you need to change the output of the RFS, but that does not necessarily mean that you need to go in and change the underlying apportionment bases.

Q. No, you do not need to, but you can do, can you not, Mr Duckworth?

A. Sometimes that will be required. Maybe some kind of further disaggregation; if a new service has become regulated you will need to do a further disaggregation.

Q. But if the apportionment bases are changing, it is also possible that, exercising its judgment, BT can change the apportionment method -- attribution methodologies. That is correct, is it not, Mr Duckworth?

A. Yes.

Q. If we keep going down, just there:

"Each item of income, cost and capital employed is attributed to a 'cost centre', according to the way in which the activity, element of plant or product gave rise to that income, cost, asset or liability. The pool of costs, assets and liabilities of each cost centre can then be attributed to further cost centres or products until each cost centre is exhausted and all revenue, costs and capital employed are associated with products and services."

So this is a sort of multi-stage attribution process and at each stage in relation to each head of cost you can have a potentially different attribution methodology, correct?

A. Yes, that is right.

Q. "The types of cost centres used in the [accounting system, the accounting separation system] are ..."

Then we go over the page:

"Activities ...

"Support Plant Groups ...

"Primary Plant Groups ...

"Support Functions ..."

{E/13/898}

You are familiar with those categories?

A. Yes, and I think we are primarily interested in the activities:

"The income, costs and capital employed associated with retail activities excluding any network costs ..."

The second two are largely network related, so we are less interested in them. Then in the final one is the Support Functions, so, yes.

Q. We are interested in the Support Functions, are we not, Mr Duckworth?

A. Yes.

Q. Yes. Right, so activities and Support Functions particularly.

Then we go down to "Concepts of Attribution" further down the page. I am not going to take you through all of it, but just picking up:

"BT's approach to apportionment ..."

You see that, the penultimate paragraph.

"... is to seek to identify the appropriate driver for each item and, as far as possible, to use objective operational and/or financial data relevant to that driver to generate apportionment bases."

Then we go over the page, {E/13/899}. So this is the approach of attribution being summarised. You then see:

"The general concepts of attribution in Accounting Separation are set out below ..."

The first one is "Revenue" which I do not think we need to trouble with, and then we are into "Costs":

"Costs are drawn from the accounting records. The processes applied to the costs, which vary according to the nature of the costs and the way in which they are recorded, are set out below."

The first one they call "Allocation":

"Certain costs can be directly associated with particular activities and plant groups and, therefore, do not require apportionment."

So this is effectively the direct costs category being dealt with, correct?

A. So not in the context that we have been looking at direct costs. So we have been looking at direct costs as sort of BT Consumer as a separate division for management accounting purposes within BT, and then the transfer charges from the rest of BT Group to BT Consumer and also kind of external direct costs.

Here we are talking about allocation where we are going down to quite detailed cost accounting, because cost data of general ledgers are very detailed, lots of cost lines, and some of those general ledger items you can say, for example, I do not know, call centre total labour costs, you can allocate that directly to a call centre activity, whereas with some of the general ledger lines, you cannot allocate them to one of the defined activities and so you need to do some apportionment.

Q. Yes. But this is talking about -- it is fairly clear

I think from the first sentence:

"Certain costs can be directly associated with [a] particular [activity] ..."

So where, from the data you have got, you can associate those costs directly with a particular activity, then you do what they refer to in this jargon as "allocation", correct?

A. Yes.

Q. Then if we go down, we have got "Apportionment", so this is the other mechanism:

"Other costs cannot be directly associated with particular activities and plant groups, and require apportionment. In the case of network costs this process makes extensive use of engineering data ...

"Certain other costs can be identified within the accounting records as relating to a discrete function such as repair centre costs, computing or billing. A review of this function, often by the means of work/application analyses or a survey of staff activity, establishes the cost driver and is used to apportion its costs between activities and, if applicable, plant groups."

So what this is saying is that if you have got a cohort of costs, say, repair centre costs, you might be able to investigate those repair centre costs in more detail and, in doing so, be able to allocate them more directly rather than merely apportion them. Am I capturing that correctly?

A. Yes, it is effectively describing a sort of actively based costing system where you try and work out -- you have a single cost line in the general ledger, but you delve into that and work out what that that was used for.

Q. Then we have:

"The remaining costs to be apportioned cover a number of central support units ... and other specialist departments that support network activities, customer facing operations and head office functions ..."

So those are ones where this kind of activity based costing may not work.

Then it says:

"Hence costs are either linked to directly --"

I am so sorry.

"Hence costs are initially either linked to directly allocated costs or apportioned to Support Functions, activities or plant groups using appropriate cost drivers. BT uses a number of techniques and sources to apportion these costs, such as surveys of staff activity, analyses of research programmes, application analyses, or operational data such as space occupancy records."

I think this is the sort of material that was touched on in the course of the hot tub as being the sorts of ways in which BT might go about looking at what we had been previously talking about as indirect costs, carrying out activity based costing surveys and being able to allocate them more accurately through the RFS, correct?

A. I think there is a risk that we kind of confuse, you know, this distinction between indirect costs and direct costs in the BT Consumer management accounts with here we are looking at some costs, so some of those indirect costs would kind of be taken in -- some costs which are recognised as SG&A would fall under the sort of allocation heading, and you will be able to say this cost is specific to voice services, whereas others, and the examples here, of functions which support kind of a wide range of activities within BT. I mean, an example is motor transport, accommodation, office space. There you cannot directly apportion that. If the office is shared by people working in the retail division and Openreach, then you might need to look at something like the number of staff and say, well, I am going to take this office building and apportion it on the basis of the number of staff, which kind of reflects cost causality, it is not a completely arbitrary apportionment.

Q. No, I do not think at any point I have used the term "arbitrary", Mr Duckworth.

A. No, no.

Q. What I was just looking at was this activity based costing system. What it does is it creates apportionment bases by, for instance, surveys of staff activity, just as an example, you agree?

A. Yes.

Q. Then if we go over the page {E/13/900}, we have got the corporate costs element, and I think we can probably leave that costs allocation element. I want to go down to the bottom of this page which talks about --

A. Can we scroll up?

Q. Yes, this was the corporate costs element that the chairman mentioned in the course of ...

A. Yes, that is -- it says:

"... wherever possible, objective data relating to the cost ..."

"... BT utilises, wherever possible, objective data ..."

So some element you can identify with cost causality, but then you are left with the rump of:

"... some corporate expenditure for which no specific apportionment bases can be readily derived."

Q. No, absolutely. So we do not know what the scale of what you refer to as the "rump" is in relation to corporate costs, but what it is doing is talking about a specific apportionment basis being developed for those corporate costs?

A. Yes, it is saying there may be some corporate costs, and maybe "rump" was the wrong -- the remainder or the residual corporate costs where objective data does not allow you to apportion them because -- and it says "readily derived". So it is not saying there is not any cost causality, it is saying it is not readily derived --

Q. I think it is a fundamental point. I think everyone understands that apart from what are formally common costs, if you could carry out sufficient degrees of identification it may well be possible to identify cost causal routes. So I do not think that is the issue here.

What I want to go down to is "Non-Financial Data". Now, this effectively says something rather similar to the material we have just seen on the previous page:

"Wherever costs cannot be directly allocated to activities and plant groups, or when plant groups do not map exactly onto components, an apportionment is required. Depending on the cost involved, the appropriate basis of apportionment may be of a non-financial nature. In these instances the relevant data may be extracted from non-financial data sources, such as [through] operational systems giving circuit numbers, or may be collected through activity analyses."

So really this is just saying a similar sort of thing to what we have already seen --

A. Yes.

Q. -- that there are a range of apportionment bases that can be used in relation to these matters, and it can include non-financial apportionment bases, correct?

A. Yes, I think, as you say, there is not a great distinction between this element of non-financial data and previously where they talked about --

Q. No. I think we are in the same place there.

A. Yes.

Q. You will see it goes on, there is an example of:

"... apportionment to activities and plant groups of the pay costs that relate to a discrete function is dependent upon a survey of the tasks of the staff whose pay is being apportioned. Such surveys will typically involve --"

I am sorry, just over the page, {E/13/901}.

Thank you.

"... analyses of the tasks staff undertake and the percentage of time spent on those tasks. These tasks will then be linked to activities and plant groups, either directly or through further analysis.

"Surveys are frequently specially commissioned for the purpose of cost attribution and are carried out at a level appropriate to the activities and plant groups in question and updated at least annually."

So this is going back to the point we saw earlier. You picked me up on it. Apportionment bases, they are revisited annually in relation to these issues?

A. Yes.

Q. You may have specially commissioned surveys, particular special analyses, looking at the different ways in which costs should be apportioned, correct?

A. Yes.

Q. We see that actually confirmed in the last paragraph of that section.

Now, I want to go two pages on, if I may.

THE CHAIRMAN: Sorry, the last paragraph?

MR BEARD: Of that section. It is just the "In summary" bit.

THE CHAIRMAN: Just a moment.

MR BEARD: Sorry, it is just below the paragraph.

THE CHAIRMAN: Yes.
MR BEARD: It does not say anything different from what has been said in several places in the material I have taken you to.
{E/13/903}
So we see in this for each item of cost that we are talking about, multiple stages of consideration, some of them involving quite sophisticated apportionment bases that are carried out for the specific purpose of this annual regulatory financial statement exercise, correct?
A. Yes.
Q. We also recognise that in carrying out these exercises at every stage, there are judgments involved in how that is to be done. You accept that?
A. There is a degree of judgment to ensure that the approach is consistent with the regulatory accounting principles, yes.
Q. But you do not suggest, and I do not think you have suggested, that the regulatory accounting principles somehow prevent there being potentially a range of attribution bases being applicable in relation to any particular head of cost, do you?
A. Well, going back to the difference between apportionment and allocation, the apportionment, it says: "where there is cost causality, you should use cost causality.

Apportionment, there is pragmatically potential different ways that you could carry this out.

Q. Yes.

Let us just go over the page then, if we may, to -- I think I may have gone too far there. Could we ... and back one more, please. Thank you. {E/13/902}.

I am just looking at 2.4. This is "Attribution to Support Functions, Activities, Support Plant Groups and Primary Plant Groups". So those were the four broad heads that we saw originally. You will see this is just explaining the first stage of this attribution process. There are lots of stages where these costs -- attribution bases are operated multiple times in relation to the same costs, correct?

A. Yes.

Q. I am not going to repeat the line of questioning in relation to each level. You can be comforted.

What I just wanted to look at here is we have got the introduction section:

"The first stage ... review each element of BT's income, costs and capital employed to establish its cost driver (the factor that caused the income, cost ... to be incurred)."

So that is what we refer to as the allocation mechanism.

Then:

"The costs and capital employed which cannot be directly and uniquely associated with a cost centre are apportioned to cost centres according to their cost drivers."

Again, we have seen all this.

"These include the costs of a number of functions such as customer facing operations ... head office type functions ... and other specialist departments that support network active introduce and customer-facing operations ... All these costs are related to activities, support or primary plant groups by their specific cost drivers, which are used as the basis of apportionment. Examples are:

"Publicity costs using campaign analyses."

As I understand it, what is being said here is that you have got this head of publicity costs that is incurred, and one way you can decide, using the cost causality principle, how to attribute those publicity costs, is to look at the publicity campaigns that were undertaken and in respect of which the costs were incurred. That is correct, is it not?

A. So my interpretation of this is you have, for example, advertising costs which is a publicity cost --

Q. Yes.

A. -- and you have a particular campaign which is aimed at a particular product.

Q. Yes.

A. You take that cost and say, well, I spent 10% of my budget on a campaign which was directed at, say, Dual Play customers, and I will take the 10% of the publicity costs and attribute them, and the indirect costs which also exhaust to that cost centre to Dual Play activities, rather than, say, not at this point in time, but broadband activities, and then, yes.

Q. No, I think we are in almost violent agreement about this, that what you are doing is looking at the pool of what is referred to as publicity costs and trying to come up with a method to allocate those costs, and what you are doing is doing it by reference to the campaign.

So as you say, if a campaign is directed purely at broadband, for the sake of argument, I know this is 2009 but let us just stay with it. If it is directed purely at broadband, you would attribute -- you would allocate those costs to broadband. If the campaign was directed at just some subset of customers, you might think about trying to allocate those costs to some subset of customers, or would that not be possible?

A. In the end you are sort of allocating to markets, and so if that set of customers is a specific market, or even

falls solely within a market, then you may be able to attribute to that market -- but, yes, you could --
Q. Is it markets, Mr Duckworth? It says "activities".
A. So activities are an intermediate stage. Activities and plant groups are an intermediate stage to then allocate finally to kind of products, and products within SMP markets, yes.
Q. Fair enough. But it is products rather than markets that we are talking about in the end?
A. Yes.
Q. So just think about this. Sometimes the advertising you undertake will be specifically product focused, so it will be for a particular type of product?
A. Yes.
Q. Other times it might be a broader campaign trying to build the BT brand. You accept that there can be a difference?
A. Yes.
Q. Now, when you carry out your campaign analyses, first of all you will have to think about those campaigns that traverse possibly the whole portfolio of BT products, will you not?
A. Yes.
Q. So there would have to be an apportionment in relation to those campaigns, yes?

A. Yes.

Q. You would have to make a judgment as to what a sensible apportionment was in relation to those?

A. Yes, I think you have identified a cost, and say it was a BT brand-driven campaign, that is an example of a cost which is truly common to all of the services provided by BT.

Q. Mr Cackett gave evidence that his view was that all campaigns have a halo effect on the brand. So in those circumstances, if you were to take Mr Cackett's view that he gave in evidence, you would have to take a component of every campaign and apportion it, correct?

A. If you took Mr Cackett's judgment as appropriate, yes.

Q. So that is the first issue that we have got here. But the other thing is that the campaigns that BT runs, whether in relation to its brand or particular products, might change from month to month, might it not?

A. Yes, and clearly do.

Q. They clearly do; and they change from year to year as well, do they not?

A. Yes.

Q. So if in one year you carry out a campaign analysis to try and operate the allocation of costs in relation to publicity matters, that might be quite an interesting snapshot for that year, leaving aside the apportionment

difficulties we have just highlighted, but it would be a snapshot for that year, would it not, Mr Duckworth?
A. Yes.
Q. But given that your publicity campaigns will vary enormously from year to year, the allocation of costs that you get in 2008 in relation to publicity might be completely different from the allocation of costs that you get in 2009 using precisely the same campaign analysis attribution basis, might they not, Mr Duckworth?
A. I think you will have two changes. You will have a change potentially in the overall spend on advertising, and, yes, the distribution of spend within that campaign -- sorry, within that overall budget on which campaigns you are focusing on may change over time. I think you said "if" there are enormous(?) changes, then that could be true.
Q. We have two issues here, that if we take a snapshot in 2008 in relation to the allocation of publicity costs, not just the attribution issue, the allocation of publicity costs in 2008 might be completely different from those in 2009 even if the budget overall is very similar, correct?
A. Yes, could be.
Q. Similarly, the situation in 2010 could well be very

different from 2009 if you carried out that analysis, correct?
A. Yes.
Q. Obviously the further away we get from 2009, and the more different products and different strategies that are adopted, the greater likelihood that any sensible allocation of costs, even if it could be done, would be completely different in relation to publicity in, say, 2015 as compared with 2009, would it not, Mr Duckworth?
A. So I think there is underlying economic drivers for why you are spending money on advertising and those fundamental economic drivers may change over time in respect to changes in the marketplace and competitiveness, but that is not necessarily to say that you would expect the amount of spend on a particular product to radically change over time if the competitiveness of that product did not change.
Q. "Not necessarily", Mr Duckworth?
A. Not necessarily.
Q. You did not really answer the question, Mr Duckworth. The question was that as you move away from the year when you have taken the snapshot, the basis on which you can take the allocation of publicity costs, and say that they reflect the allocation of publicity costs six years later, ten years later, almost 15 years later, is not

a tenable position, is it, Mr Duckworth?
A. To be clear, I do not take the allocation basis from 2009 and then apply that to, say, marketing costs in 2015. What I do is I take the overall unit costs and project those forwards. Now, implicit within the unit costs in 2009 are a set of allocations.
Q. Yes, and therefore those allocations that are, as you fairly put it, implicit in the unit costs we would expect to be vastly different 10 or 15 years later, just in relation to this publicity allocation, would we not?
A. I think there is a distinction between the allocation being different and the resulting costs being allocated to SFV. So you could have -- in 2009 there was no expenditure on BT Sport promotions. So, yes, clearly by 2015 BT Sport -- you know, BT had invested a huge amount of money in Champions League rights and had a strong economic incentive, given that was effectively, at least in the short-term, a certain cost, to spend lots of money on promoting packages which included BT Sport.
So there was definitely likely a shift, probably an increase in overall expenditure on sales and marketing, and definitely a shift from, you know, SFV as a proportion to a new product which did not exist previously.
So, yes, there would be a shift in allocation. Now,

whether that means that the unit costs that you would attribute to SFV would go up or down is another question.

Q. Yes. But you do not know, do you, Mr Parker? Mr Duckworth, I am so sorry. You are taking on very many characteristics today.

A. I think I have been called "Dr" at least once today, which is nice.

Q. Would you like "Professor" at some point?

A. Thank you.

Yes, that is right.

Q. The reason why, as you rightly picked me up, the attribution bases were reviewed every year was not just because of allocation but because for those attribution issues you needed to think about how those should properly be done, say, in relation to publicity. That is correct, is it not?

A. Yes, an example is the introduction of BT Sport. If you were replicating the RFS then you would need to introduce a whole set of activities related to BT Sport and --

Q. It is not just that. We are dealing with voice here, are we not?

A. Yes.

Q. So one of the things we are thinking about in relation

to publicity is BT publicising and advertising its voice services. You understand that, Mr Duckworth?
A. Yes.
Q. Those voice services from 2009 onwards were voice services involving both Standalone Fixed Voice and voice within bundles, did it not, Mr Duckworth?
A. Sorry, can you clarify the question?
Q. From 2009 onwards the provision of voice services by BT was both through what is called SFV, Standalone Fixed Voice, and through voice as part of bundles, was it not, Mr Duckworth?
A. At the beginning of the question you were referring to promotion costs or is this just a general question?
Q. I am talking about the situation where BT, which has a reputation for providing telephony services, provides telephony services?
A. Yes.
Q. From 2009 onwards it provides those telephony services both on a standalone basis and through bundles?
A. Yes.
Q. If it wants to publicise the fact that it offers telephony services in circumstances, for example, where there are a number of entrants into the market, it may well publicise the virtues of BT telephony services, might it not, Mr Duckworth?

A. It might.
Q. Yes. In doing so it is then publicising services both in bundles and standalone, correct?
A. So this is a hypothetical campaign which is --
Q. Yes, it is a hypothetical campaign.
A. Which is --
Q. I am not trying to put myself in the place of a BT campaign. I am saying if BT, as a telephony provider wants to promote its voice services and it offers a campaign that promotes BT telephony, then in relation to that campaign in respect of apportionment you would have to take on a completely different approach to apportionment of those costs as compared with a situation before it started offering those services in bundles; is that correct?
A. Yes.
Q. So we know from 2009 that it did do that, do we not, Mr Duckworth?
A. It did do what?
Q. Offered telephony services in bundles that it was not able to do previously?
A. Yes.
Q. Therefore, I have dealt with the allocation issues changing. What I am talking about is the apportionment bases potentially radically changing as well. You

understand that if you were to carry out a campaign analysis at that point you would be talking about a campaign that covered voice services generally and you would have to think about the apportionment mechanism between standalone and bundles services if that was what you wanted to feed through into the regulatory financial statement in a putative 2010?
A. Yes, a hypothetical campaign for voice telephony in general.
Q. Yes.
A. Then applying that in a hypothetical regulatory financial statement.
Q. In 2010.
A. Then, yes, obviously it is introducing a new set of products. Then you need to consider how to apportion costs amongst those products.
Q. So the point I am making is just taking this very first example, when you take the snapshot in relation to 2009 in relation to allocation where you can just attribute by campaign we cannot carry that across multiple years with any confidence. But the same is true of attribution bases that you use for attribution of costs that are shared across different products as well, is it not, Mr Duckworth?
A. When you say "shared costs", do you mean kind of joint

or common costs?

Q. I used a non-technical term. I was trying to actually avoid getting into that because I was talking about the costs of the campaign for voice telephony in 2010. My hypothetical campaign I completely accept.

A. Sure, and that I would consider to be a sort of fixed and common costs but some shared costs, so customer care, for example. You know, there is a lot of sort of cost causality embedded in that customer care cost and so you would not necessarily need to adjust the apportionment methodology. You would need to take account of the fact that you have got more products but you would still be apportioning based on surveys of --

Q. You might be. So there are two issues there. First of all, I think you accept that if you were to keep using the same survey methodology the apportionment that you would use in relation to my hypothetical voice campaign would be radically different from the position in 2009. But there is a further point, is there not? Survey methodology can change year-on-year as well, can it not, Mr Duckworth?

A. Yes.

Q. So it might be completely reasonable for these attribution bases that you rightly picked me up on get changed annually to be varying year-on-year throughout the period when we have the RFS and therefore they could, if we carried on with the RFS, have been radically different in 2010, 2015, 2020?

A. Well, I think, you know, given that they are trying to capture costs causality as the example you give where you have Voice Only Customers and voice delivered in Dual Play, as the relative proportions of those customers change over time. Of course if you look at customer care costs there will be a shift in terms of apportionment from the decline in Voice Only Customers to the increasing Dual Play customers, so yes, that is self-evident.

Q. Let us just look at the staff work analyses of customer service centres because that is sort of a species of your custodial customer care point, is it not, which is the next example on that page. {E/13/902}. We know that there was an extensive and expensive programme of reshoring customer service?

A. Yes.

Q. That was after 2009. We know that too. So what you have here is that during this 2009 RFS you had a staff work analysis which allocated costs of customer service centres to different activities or support or primary plant. It seems a little unlikely for primary plant I have to say but --

A. Who knows.
Q. Yes. In those circumstances you have got staff work analysis being carried out but you would accept that when you rejig your customer care system and you reshored these arrangements, first of all, the costs of those arrangements may change radically. That is the first point: the costs of customers changing?
A. Yes, I think we are generally agreed that onshoring increases costs. It is a quality improvement and that will increase the incremental cost of serving customers who call in to customer care service.
Q. It is more than that, is it not, because if you reconfigure your customer care system, even if you use the same metrics for staff analysis you would expect once you reshored your customer service you might get a very different outcome as to the staff work analysis of people because you were reorganising your system more generally, agreed?
A. (Pause) Well, you have customers -- so call centres do two things. Outbound calls where the call is initiated from the call centre and inbound calls where the customer is making a call to the call centre. The volume of calls made to the call centre, to kind of a first order, is not going to change because that call centre -- I am talking first order, maybe the second

order effects obviously but the first order it does not matter whether that call centre is in England or in the Philippines. If you have a fault on your line you need to make a call to tell BT there is a fault on the line. Presumably you will be using someone else's line in this case.

So the kind of, the distribution of calls across customers is not going to be changed by onshoring. The cost of then answering that call, yes, I agree that will change. It will have a higher cost when the customer service agent is based in the UK being paid the UK level of wages compared to being based in the Philippines being paid wages there.

Q. Just to be clear, reshoring is not just bringing the call centres into the UK. It can involve a change in the organisation of the call centre, a different strategy in relation to customer service and a whole range of developments in relation to the way that you deal with your customers and prospective customers. You understand that, do you not?

A. I understand that, but the point I am making is, what we are primarily interested in when comparing to prices is the unit cost or the unit incremental cost and a reasonable attribution of fixed and common costs for doing that. So a reorganisation would not at first

order change the number of calls. You would expect BT to be trying to make efficiency improvements. They would re-organise to reduce the total costs of serving customers and if anything that would bring down the unit costs and we have said there is a countervailing which is a quality improvement which is you are bringing on in the call centre operative from outside the UK to the UK which leads to an increased in cost. So in terms of unit costs, yes, there is an increase in unit cost from the increase in quality, perceived quality. But the reorganisation, if anything you would expect that to be reducing costs or potentially increasing quality.
Q. I am sure that when they reshored the call centres they tried to do so to minimise the amount of extra costs they spend?
A. Yes.
Q. BT is rational in that regard?
A. Yes.
Q. So I do not think there is any question there. The question I was asking you is: would the staff work analysis that you carry out in one year necessarily be the same or different in another year where you had had a fundamental dislocation in the way that you delivered your customer care services through call centres? I am suggesting to you that even if you use precisely the

same staff work analysis the outcome of that could be completely different?

A. Yes, and I completely agree with you. You have got a different set of costs, which you then map -- try to map on to the products and yes, so ...

Q. In relation to that of course the staff work analysis itself is the attribution basis that you are using or the allocation mechanism that you are dealing with, depending on whether or not you can apply, and that could change as well, could not it?

A. Yes.

Q. Let me briefly deal with the next two. Accommodation costs.

THE CHAIRMAN: Can I just -- well, I do not know how long you are going to take on the next two.

MR BEARD: I am going to deal with this pretty quickly. I was going to get them done in the next five minutes.

THE CHAIRMAN: Thank you.

MR BEARD: Accommodation costs. Here it is done on the analysis of space occupied?

A. Yes.

Q. Now, in very simple terms the estate of BT in 2009 might be very different from the estate of BT in 2015, might it not?

A. It depends on which part of the estate you are talking

about. Clearly there is "network exchange buildings".
Q. Accommodation, I am focused on. I am not interested in --
A. Office accommodation.
Q. Yes.
A. There is accommodation exchange buildings.
Q. Okay, fair point.
A. Office buildings, yes.
Q. I can see that when it talks about accommodation buildings on space occupied it might be talking about exchange accommodation as well as office accommodation?
A. Exactly.
Q. I can understand that. I am not disputing that. Let us just focus on the office accommodation although that is not the correct way to think about things, is it, because as BT develops its network it actually changes where its exchange hubs are, does it not?
A. It is planning to do so, and it has shut down a small number of exchange -- this is slightly irrelevant. But it is having great difficulties in shutting down exchanges because you have still got copper connected customers into those exchanges and so I think there have been two or three exchanges shut down. It is not a quick business.
Q. As I say said, let us focus on the office real estate

for these purposes because that is really what I am just interested in. The office real estate portfolio that the BT had in 2009, there is no reason to think it is identical to the office real estate that it has in 2015 or 2020, is there?
A. No, those clearly change reflecting changes in the demand for office space, the number of people etc..
Q. You cannot tell whether that is going to be comparatively more expensive, less expensive or the space occupied by individuals is more or less in relation to those changed environments, can you?
A. The kind of unit costs of office accommodation, no.
Q. So if we did an accommodation costs analysis on the basis of space occupied in 2009 it could be radically different if we did the same analysis, using precisely the same criteria in 2015 or 2020, agreed?
A. The apportionment or the unit costs? I accept that both the unit costs of the costs of having one person may change over time reflecting rental rates, but also the apportionment as different divisions of BT grow and shrink, yes, I believe the apportionment will change.
Q. Finally in relation to computing costs, so the computing costs, again taking a budget of computing costs and the idea is that we would allocate them because I think we are -- although it talks about apportionment it would be

thinking about this initially on the basis of allocating to particular projects or applications which would then presumably be allocated to particular products if that project was exclusively for the purpose of operating a particular product, correct?

A. Yes, and there is also sort of potentially computing costs which are there to support the network, so it is not just kind of retail computing costs, so, yes.

Q. Let us just be clear. In relation to this, for instance, if you put in a new IT system for billing that would be a system whereby it would be difficult to apply it to particular products. You would have to take that project computing project cost effectively and apportion it to the different products in respect of which the billing IT services were provided, correct?

A. I think in the case where you considered -- so you could take a very narrow view of cost causality or you could take a slightly more intricate view of cost causality. If you say: "try and understand the rationale for introducing a new billing system", is this to compete for bundle services? Then potentially even though that brings benefits to SFV customers you might say: well, the primary driver of delivering this computer system even if it is a billing system for all products -- perhaps you are not able to deliver Dual Play services on your current billing system and so you need to spend money on upgrading your billing system but that new billing system also serves SFV services.

There is obviously a question of: would you allocate that or attribute that cost to SFV services if the true underlying driver of upgrading the billing system was actually to serve Dual Play customers?

Q. The point I am making here is, in 2009 you incur certain computing costs but you do not introduce a new billing service. You do in 2010. In 2010 even if you use the project application analysis, you will end up with a completely different allocation and attribution of those costs in 2010 if you have run the RFS again; that is correct?

A. Yes, and it could go up or down, yes.

Q. Just to be clear, let us go to {OR-F/843/1}. So this is a document from September 2009. Do you know -- are you familiar with this document?

A. I do not recall --

Q. Have you seen it?

A. I cannot recall having reviewed it.

Q. If we flick through to page {OR-F/843/2} just so you can see what it is.

A. Yes.

Q. So last point:

"We now have to retain customers and invest to build a platform for future sustainable growth."

If we go to slide {OR-F/843/10} this is strategy aims and one of the things at the top is something we have seen in other slides: the "Right First Time", so changing the strategy in relation to customer services and improving it.

Page {OR-F/843/14}. If you just zoom in on that.

"We will be launching competitive bundles for consumers.

"Barriers limiting BT's bundle launches are being lifted. New IT systems will enable single billing of multiple services to consumers."

So here we have exactly that example of post-2009 a very large investment potentially. The level for these purposes does not matter. But even if you use the same methodology that had been used precisely in 2009 you would likely end up with a radically different allocation of attribution of those costs in 2010 in a putative RFS, would you not?

A. So I think this kind of caused the judgment about a new IT system which enables single billings of multiple services to consumers where you have SFV customers who clearly do not benefit from that.

So if you took the billing system as a common cost across all services because it serves all customers, you might say: well, we will use the same attribution methodology. If you say: "well, actually we are incurring this cost to deliver bundle service", then you may change your attribution methodology and I would say: yes, we --

Q. I completely accept that you might also change your attribution methodology which would make a further change. But my question was, even if you used the same attribution methodology in a putative 2010 RFS you would come up with a radically different allocation and attribution than you had in 2009?

THE CHAIRMAN: I am sorry, I do not understand the question. If you have the same attribution methodology?

MR BEARD: Yes, so if you are using exactly -- whatever it is that they use as their project application analysis is the attribution and allocation methodology in 2009. If you apply that in 2010 in relation to a brand new IT system that has been invested in, then the outturn of how those costs are attributed and allocated could be radically different and the levels of cost you see in relation to those services could be radically different in a putative 2010 RFS, correct?

A. Yes, you know, changes in cost, change in distribution, yes.

Q. In addition, as you rightly say, you could also change the attribution methodology in 2010?
A. Yes.
MR BEARD: Thank you. I am sorry, for the indulgence.
THE CHAIRMAN: Not at all.
MR BEARD: But we got through those four. It now is probably a convenient moment.
THE CHAIRMAN: Yes, thank you very much. Can I just ask, I am not going to hold you to it, but how much longer do you have, do you think?
MR BEARD: I think I probably have at least two hours more.
THE CHAIRMAN: We had better stick to our 9.30 thing, given that we have to finish at 3.30.
MR BEARD: Yes.
THE CHAIRMAN: Just one second. (Pause). I think in order to allocate the time equally you will have to finish by about 11.30 tomorrow, because there may be some re-examination as well.
MR BEARD: Yes, of course. As previously, I will just cut my cloth.
THE CHAIRMAN: Yes, just to get an idea, yes.
MR BEARD: I should say, there is a chunk of material that I may need to deal with in closed session, just because there are confidential numbers, and in order to be fair to the witness it is very difficult to ask questions by

pointing to --

THE CHAIRMAN: Absolutely.

MR BEARD: So it might mean that I have to diverge from the line I am on at the moment and come back to it, but it might be sensible actually to start in closed session first thing tomorrow morning and come back, because that just means that we do not have to have two breaks.

THE CHAIRMAN: Then everybody here who knows they cannot come in, because that is part of the confidential ring ... Right.

Ms Kreisberger.

MS KREISBERGER: Sir, I should just say, in the hope that it is helpful, at the moment, and I do not want to be pinned down to it entirely, but at the moment I do not anticipate being longer than an hour, possibly less, tomorrow, so I should just mention that.

THE CHAIRMAN: Right. Just a minute then. (Pause).

We will keep it to 9.30 but thank you for the indication.

MR BEARD: I am grateful.

THE CHAIRMAN: Thank you very much. 9.30 tomorrow then, please.

(4.40 pm)

(The hearing adjourned until Thursday, 22 February at 9.30 am)

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