IN THE COMPETITION APPEAL TRIBUNAL

Case No: 1524-1525/1/12/22

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

Monday 6th November – Friday 1st December 2023

Before:

The Honourable Mr Justice Marcus Smith
Eamonn Doran
Professor Michael Waterson

(Sitting as a Tribunal in England and Wales)

BETWEEN:

Appellants

Pfizer Inc. and Pfizer Limited & Flynn Pharma Limited and Flynn Pharma (Holdings) Limited

V

Respondent

Competition & Markets Authority

A P P E A R AN C E S

Mark Brealey KC, Robert O'Donoghue KC & Tim Johnston (Instructed by Clifford Chance LLP) on behalf of Pfizer

Jemima Stratford KC, Tom Pascoe & Alastair Richardson (Instructed by Macfarlanes LLP) on behalf of Flynn

Josh Holmes KC, David Bailey, Jennifer MacLeod, Julianne Kerr Morrison & Conor McCarthy
On Behalf of the Competition & Markets Authority

Wednesday, 8 November 2023

(10.30 am)

Opening submissions by MS STRATFORD (continued)

MS STRATFORD: Good morning. A couple of pieces of housekeeping, first of all, arising from yesterday.

First, I said I would provide a short hand-up showing the by strength breakdown of the £66,000 per year --

THE PRESIDENT: Yes, thank you.

MS STRATFORD: -- that Flynn would have made on phenytoin if the CMA were correct about the reasonable rates of return for both Pfizer and Flynn.

Happily those figures are already in the bundle. They are in appendix A to Dr De Coninck's seventh report which is appendix A of CRA-7. In particular, it is table 10 of appendix A, but for ease we have set it out on one sheet of paper.

If you want the bundle reference, just for completeness, it is {XE1/12/51-52}. So that is that. I do not think I need to go through it, and there really should not be anything controversial.

THE PRESIDENT: No, it is really just putting references on the bones of what you said yesterday which is very helpful.

MS STRATFORD: Exactly. It is all using CMA assumptions,

I should say.

Of course they do not accept the premise, I am not suggesting that.

MR HOLMES: Sorry, I do not want to interrupt, but it is not uncontentious and it does not use CMA assumptions, but I will address you, if I may, about it when we come to that.

THE PRESIDENT: We will treat it as a contentious document intended to assist Ms Stratford in the point she is making.

MR HOLMES: I am grateful.

MS STRATFORD: Fine. In some respects it uses CMA assumptions.

The second bit of housekeeping is parallel imports --

THE PRESIDENT: Yes.

MS STRATFORD: -- which was the subject of some discussion yesterday and my instructing solicitors have written a very -- I suggest very helpful letter and I do not know whether that has reached you yet.

THE PRESIDENT: That has reached us and again we are very grateful for the flesh being put on the bones.

MS STRATFORD: Yes.

THE PRESIDENT: We do not regard it as something that is anything more than background, but of course, if there

is a dispute about what is said, it seems all very clear and uncontentious, but if there is a contentious element then I am sure we will be told.

If we were really zoning in on this and it mattered then of course we would make it clear, but we are really just trying to make sure that we can explain the system in a manner that is, broadly speaking, bearing some resemblance to reality. That is really the aim.

MS STRATFORD: I am very grateful, but hopefully since it just refers to the original CMA Decision and a government website, it is dangerous to say but I hope it is not controversial.

Just on the notes, it may be helpful for you to know, I think someone has very sensibly started a bundle called XO which hopefully is available on your system where hand-ups are being put.

That is all I wanted to say by way of housekeeping.

Where I got to just before lunchtime yesterday was introducing my section 4 on Flynn's reasonable rate of return, and I explained I am mainly going to cover three things: one, the approach, theoretical versus empirical; two, the metric, ROS versus ROCE, and three, the size of Flynn's reasonable rate of return.

So diving into the first question, theory versus empirical analysis, I am not going to spend long on this

at all because I showed you yesterday what the Tribunal previously found, that the CMA should have focused on empirical analysis rather than theory, and we say the CMA has not heeded that advice and has maintained a theoretical approach.

To bolster that, the previous Tribunal's conclusions are consistent with what has been said in other cases, and just to give you two references, I am sure both are -- I know both are very familiar. The first is *Hydrocortisone* at paragraph 331.1 of *Hydrocortisone*, bundle reference {XN2/29/164}, no need to turn it up. The Tribunal there emphasised that comparators are of particular importance and went on to say that a counsel of perfection should not be applied in identifying them, and that was a comment in the context of a discussion of the correct methodology for identifying excess.

Second, in *Liothyronine*, it is paragraph 135 of *Liothyronine*, where the Tribunal held, drawing upon the judgment of Lord Justice Green in *Phenytoin*, that -- and I quote:

"... the counterfactuals of greatest practical value are often those drawn from real life, as opposed to some hypothetical model."

Again, just for your note, that is at {XN2/28/49}.

That is really, for the moment, all I wanted to say

about the correct approach to identifying a reasonable rate of return. We say it is not seriously capable of dispute that in most cases, at least, an empirical real-world analysis is to be preferred to a theoretical one.

The second question is the correct metric for calculating Flynn's reasonable rate of return. Now, we have set out the history of this issue at paragraph 36 of our skeleton. I do not need to go to it now, but it is at {XL/2/16}. I am not, as I say, going to go back over it in opening not least because Professor Waterson will recall perhaps better than me, who was not there, the CMA's previous position, but we do respectfully ask the Tribunal to look at the collection of previous statements that we have set out when there is a convenient moment.

I just wanted to go to two documents at this stage. The first is the CMA's original statement of objections, and that is at {XA2/2/253} if that could come up, please, thank you, and particularly to look at paragraph 5.92 of that. I take this example because it shows what the CMA's view was from the beginning of its first investigation, and you can see there it found that:

"... ROCE is challenging to apply for Flynn and has

limitations given that its activities in supplying phenytoin sodium capsules, namely ordering and managing customer relations, are people intensive, meaning that Flynn employs minimal capital assets. As a result [and I stress], the CMA considered that ROCE was not appropriate for assessing what a reasonable [rate of] return would be for Flynn."

The second document I wanted to show you on this is Mr Harman's report from the -- one of his two reports from the first appeal where he endorsed this view. So if we could please go to {XE1/14/39}, and as I say, this is in Mr Harman's second report, I wanted to focus in on paragraph 4.32 where Mr Harman begins by accusing us -- with hindsight there is a certain irony in some of this, but he says we have misinterpreted his ROCE analysis, and I quote:

"... as suggesting that a high ROCE in itself indicates excessive profitability."

Then he says:

"This is not the intention of my analysis. I do not suggest in my First Report that a finding of a high ROCE for a particular Flynn product would be indicative of excessive pricing. It is common ground that a ROCE analysis is not appropriate for establishing excessiveness in this case."

The CMA is now adopting the opposite approach. It says that ROCE is not only a suitable metric for Flynn, not for Pfizer, they have stuck with ROS there, but for Flynn we have moved to ROCE. They say it is the most suitable metric.

Now, what has happened in between these two contradictory positions? The answer is nothing save that the Tribunal has found that the CMA should have examined comparators and real-world evidence more closely.

So one can see what has gone on: the CMA has been told in clear terms by the Tribunal: go away and look at real-world evidence on rates of return. So it switched horses to an analysis which it says relieves it from any need to look at any such evidence because it is based on theory alone.

The CMA, as you will have seen from the skeletons, says that it has uncovered new evidence that justifies the change of position.

I am afraid to say that this is disingenuous. If the Tribunal has looked through the Decision and the defence with this question in mind, you would be forgiven for failing to identify what this new evidence actually is, and the CMA is pretty coy about it, frankly. The best we are given is Decision

paragraph 5.59, which if we could go to that at {XA1/1/160}.

I am looking at 5.59. The CMA first relies on a statement by Dr De Coninck, who of course is not a factual witness, that Flynn had:

"... very little fixed capital employed..."

Well, that is hardly a revelation. As we have seen from the statement of objections, that is what the CMA had been saying from day one.

Then the CMA identifies three further pieces of what it calls "new evidence", all of which are statements by Dr De Coninck in his oral evidence, and you can see that in the footnotes.

I am certainly not going to go through each of them now, save to say that not one of them was news to the CMA or anybody else who was sitting in the courtroom for the first appeal. Indeed, all of them were reflected in Flynn's financial statements which the CMA has had all along.

So in short, we say the CMA is clutching at straws to justify its change of position, and I note that relatively little is said about this in its skeleton. You get something, with respect, fairly thin at paragraph 122.

THE PRESIDENT: Does it actually have to justify its change

of position? I mean, could it not simply reach a fresh decision?

MS STRATFORD: It can, of course, change its position. We have here -- obviously all this is going to be explored in evidence, but we have not only the CMA but Mr Harman saying -- and that is why I took you to those particular passages -- that ROCE was not suitable for Flynn, explaining the reasons why, and that ROS was.

So we do submit quite strongly that it calls for very serious explanation for not only the CMA but its expert, independent expert, to then come to this Tribunal with basically diametrically the opposite view. It is an expert view that is put forward by the CMA as a regulator and then supported by Mr Harman in his expertise, and the purported justification is, well, the evidence, that is what they say, the evidence has changed, we can do this confidently now in a way that we could not before, which is why it is important in my submission to look at really what is the evidence that supposedly came out of the hat at the first --

THE PRESIDENT: I can certainly see that the history might be used to attack or undermine the findings in the present Decision and say: look, you could have done this before, you did not, that rather suggests that what you have done now is not very good, and I understand that.

I suppose what I am slightly pushing back on is the suggestion that one sometimes gets when one is, say, justifying a decision on appeal where there has not been a reconsideration at the administrative level. There the CMA is quite properly constrained in what it can do by way of changing its position.

I mean, you can do it if there is an attack in the appeal which is raising a new point that needs addressing, but you cannot go outside the scope of the decision otherwise, but that is not this case. Here you have a history which may undermine the substantive outcomes found by the CMA and you look to the history for that reason. You say well: you know, you have changed your mind for not very good reason, that is what you are effectively saying, and we will say: let us look at the reason and see whether that is borne out, but that is as far as you go.

MS STRATFORD: We put it a bit higher than that.

THE PRESIDENT: You put it higher than that.

MS STRATFORD: We put it a little bit higher than that, but I am certainly not advancing it as a jurisdictional argument.

THE PRESIDENT: No.

MS STRATFORD: Of course, as you know, sir, we go then to deal with fully with ROCE on its merits, so we are not

saying that the Tribunal will necessarily stop here --

THE PRESIDENT: No, no, I am grateful.

MS STRATFORD: -- but it is, with respect, this is not some kind of superficial merits point. I do urge careful consideration of what the CMA was saying last time. It was not just: oh, we have got ROS, we have got ROCE, well, let us use ROS. I am being very colloquial now, but you get my sense.

THE PRESIDENT: Yes, I certainly (inaudible).

MS STRATFORD: They specifically addressed and explained why ROCE was not appropriate for Flynn and Mr Harman, with his independent expertise, signed up to that and said it was not appropriate for establishing excessiveness in this case, and we do say that that is an important starting point when the Tribunal comes to consider what has happened now on remittal.

Moving on, apart from what we see as a volte-face, what is the problem with applying ROCE to Flynn, and the problem is precisely what the CMA said it was in its first investigation, that Flynn's business is driven by people skills which cannot readily be quantified.

So Flynn's business is not akin, for example, to something like an energy generator which makes very large capital investments in things like plants and machinery and then measures the return on those

investments, and to use Dr De Coninck's words, the reason that a company such as Flynn's returns on capital look high is because the denominator in the ROCE calculations, in other words, the amount of capital employed, is very low, not because returns are very high. There is no need to go to it, that is in the CRA position paper at paragraph 22(a).

Obviously this will be a subject for the hot-tub and potentially cross-examination in due course, so I am certainly not going to go into the finer detail in opening, but there are two very simple indicators, we say, that ROCE measures are meaningless when applied to companies like Flynn.

The first is the ROCE rates of Mr Williams' comparator companies, and if I could ask you here to turn up -- it is at bundle {XE2/7/12}. This is in Mr Williams' seventh report and I wanted to look at paragraph 42. These are all companies, as I will explain in a moment, that are very similar to Flynn. Their ROCE rates are nowhere near Mr Harman's theoretical 10% rate of return.

Over the page {XE2/7/13} at paragraph 44, Mr Williams acknowledges very fairly there that his fifth comparator, Alliance PLC, has a ROCE rate of exactly 10%, but this makes our point for us because

what sets that company apart is that it is sitting with very large amounts of capital on its balance sheet. So that is my first point, Mr Williams' comparators and look at what the ROCEs look like for those companies.

The second indicator that the ROCE metric is unsuitable is one of the graphs that Dr De Coninck has produced in his seventh report, so this is CRA-7 at bundle {XE1/12/16}, please. This shows the ROCE rates of Flynn's other products.

Now, a lot of ink has been spilt by the economists on the way in which ROCE is calculated for Flynn's other products, and I may need to pick up some of that with Mr Harman in due course.

This graph seeks to control for those disagreements by setting out the figures on different accounting bases, and the simple point I make at this stage is that no reasonable person can look at the figures and say that it provides support for the proposition that a 10% return on capital is normal for a company like Flynn.

The returns fluctuate wildly, which is actually what one would expect for an asset-light company whose business is not driven by capital investments. For those reasons, which I will explore further with Mr Harman as appropriate, we say the CMA was correct in its original view that ROCE is not a suitable metric for

Flynn. The true reason for the volte-face is the CMA's drive to avoid empirical evidence, but we submit that is also the vice of its approach.

Now, assuming for a moment against myself that ROCE was a suitable metric for Flynn, the CMA and Mr Harman could have gone to the market and obtained the ROCE rates for some other companies. Mr Williams, as you have seen, did that on the basis of his comparator companies' accounts, but the CMA conspicuously did not do that.

If the Tribunal reads the Decision, the CMA's defence, Mr Harman's report for this appeal, it will not find a single piece of empirical evidence about the rates of return on capital achieved by a company such as Flynn or indeed any company.

Instead, what one has is a mathematical equation, and if we could go, please, to {XE1/15/25}, this is in Mr Harman's third report, as I have said his report for this appeal, and looking at paragraph 3.2.16, this is really, if you like, the nub of Mr Harman's entire report for this remittal appeal, and he says there:

"Based on the theory above, it is also possible to test whether a firm's actual return (eg, as measured by ROCE), is above a competitive profit benchmark (ie, WACC), in percentage terms. [This] can be summarised as

follows:

"ROCE (%) [is greater than or equal to] WACC ...

"The CMA ... performed this test."

Mr Pascoe -- I am sorry, I am trying to go too fast. At the beginning of 3.2.14 we can see that all of this is in the context of calculating a reasonable rate of return, hence a reasonable rate of return.

THE PRESIDENT: Yes.

MS STRATFORD: Thank you.

Just breaking down what Mr Harman is saying there, the competitive profit benchmark that he refers to is another name for the CMA's reasonable rate of return, it is its plus. That is what the reasonable rate of return is. Mr Harman equates this competitive profit benchmark to the WACC, as he says "ie, WACC". He then expresses it as a formula which means in substance that wherever a company's return on capital is above its cost of capital, that company is earning above what he calls a competitive profit benchmark.

So just to put that in concrete terms for a moment, if a company gets its capital from the bank through a loan with, say, a 10% interest rate, Mr Harman is saying that if that company's returns exceed 10%, it is earning something above a competitive profit benchmark.

There is no real-world evidence that a company's

return on capital under conditions of normality equates to its cost of capital, either in this industry or any other. Indeed, the real-world evidence, and I have shown you just a flavour of it for the moment, the real-world evidence suggests the opposite.

Mr Harman answers this point in several places --

THE PRESIDENT: By the real-world evidence in that instance you mean simply the returns that capital-light enterprises generate in that they are generating a return on capital that is well in excess of 10%?

MS STRATFORD: Yes.

THE PRESIDENT: You are not looking at financing costs of those companies in order to justify the higher than 10% rate?

MS STRATFORD: Yes. I am going to come on to this point. The only place where Flynn can actually look at other products is in relation to its own other products, so I am really focusing particularly on that, and I am going to come on to the implications of that. Williams' comparator companies, obviously he has been able to look at the company accounts and see what that says.

Now, Mr Harman answers this point in several places with a sleight of hand, and we have called this out quite clearly in our skeleton argument, because he repeatedly says that his ROCE analysis is based on

empirical evidence of average returns in the pharmaceuticals market. I have in mind in particular our skeleton at paragraph 45, and at footnote 88 there we collect together some of the references.

The CMA uses a similar formulation at paragraph 128 of its skeleton, that is at {XL/3/56}, but no need to go to it now, and I am afraid again we just say that is not right. There is not a single reference in the Decision or Mr Harman's report to an actual rate of return earned by an actual comparator company, just as there was not in the original appeal as Professor Waterson in particular will recall.

The only empirical observation that Mr Harman's analysis is based upon is a frankly superficial analysis of the cost of capital in the pharmaceutical industry.

So in my example, that is the 10% interest rate earned by the bank, but that is -- I am sure it does not need stating -- crucially different from any empirical testing of companies' returns on capital which is what would be required to test Mr Harman's hypothesis that cost and return should converge.

The question of whether companies' returns on capital converge with their cost of capital is what the CMA and Mr Harman ought to have been testing empirically, but that is precisely what they have not

done, and of course, I should say, for the avoidance of any doubt, this is all subject to my threshold objection that ROCE is not a meaningful metric for this case anyway.

Now, this is the same analysis as that which Mr Harman put forward as a cross-check in the original appeal and which was, as I have said, rejected there for being theoretical and based on idealised competition. The only things that have changed between the two analyses, or the only thing that has changed is the WACC rate, and we say that is a very superficial change.

I can take this very quickly, but I hope it is useful, Mr Harman's previous analysis was based on a WACC of 9% to 12% which had been sourced by looking at the capital costs of some large pharmaceutical firms such as GSK and AstraZeneca. No need to turn it up, but for your note, that is in the original Decision at paragraph 5.110 which is at {XA2/1/313}. Mr Pascoe rightly says I should emphasise they were looking there at capital costs, not capital returns, in the original Decision.

What the CMA has now alighted upon in support of its 10% figure, which obviously -- the 10% falls somewhere in the middle of its original range, is an investment bank presentation to Flynn, and if we could just pull

that up, it is at {XG/242/16}. This is the so-called Jefferies presentation.

For context, this was a pitch -- I hesitate to call it a sales pitch, but it is basically what it was -- it was a pitch to Flynn by an investment bank when Flynn was considering a sale of the business. There is no need to go to it, but Mr Fakes deals with this in his first statement at paragraph 90, {XC1/1/38}.

The 10% figure comes from the green box which you can see about halfway down the left-hand side of the page, where it is headed:

"Discounted Cash Flow Analysis."

Dr Fakes actually explains that this is likely to be a reference to the acquirer's cost of capital, not that of Flynn, that is at paragraph 93 of his first statement {XC1/1/39}, but the most important point is that this is obviously not empirical evidence of Flynn's or any other pharmaceutical company's return on capital, it is just a cost of capital figure.

This document really represents the only real change between Mr Harman's ROCE analysis in the first appeal where he was using it as a cross-check, which was rejected, and his analysis in this appeal.

I am going to move on, then, if I may, to our margin comparators, so this is the third main question I am

addressing in my fourth section.

As I have said, the Tribunal faces a fairly stark choice here between the CMA's reasonable rate of return which is based on Mr Harman's theoretical equation, and our reasonable rate of return which is based on market evidence.

Just a quick note on a point of terminology, if I may. We have referred to our evidence on industry margins as comparator evidence, and that is an accurate description. I am not saying there is anything wrong with that, but it is important not to confuse this with the price comparators which are relevant under limb 2.

It may be more helpful to refer to our analysis, and I am not saying I am going to manage to do this consistently or at all, but it may be more helpful to refer to it as empirical market evidence. So it is the evidence that informs the question of what is a reasonable rate of return for Flynn, and the Tribunal has itself already pointed out that comparators may not always be the most apt term in a different context. So I just wanted to mention that aside.

Coming to margins, there are two types of empirical data that we rely on: one, the returns earned on Flynn's other products, and two, the returns earned by other similar companies. This empirical data matters because

the CMA is supposed to be identifying a benchmark which reflects a normal competitive rate of return. That much, I venture to suggest, is common ground.

As the original Tribunal held, empirical evidence is or should be central to that calculation, and the empirical evidence is also important for the related reason that Flynn must not be punished for exceeding a rate of return which its competitors exceed. That would be grossly unfair for reasons which I do not need to state.

There are just two points of principle on this market evidence which again, I do not understand to be controversial. The first is that the CMA should take a weighted rather than a binary approach to comparators. That is what the Tribunal held in the original Tribunal judgment. We do not need to go back to it because it is paragraph 324 which we looked at together yesterday. We do not understand the CMA to dispute this at the level of principle. That does not mean that the CMA can never dismiss a comparator outright, we are certainly not going that far and we do not need to go that far, but mere imperfections should not be used by the CMA as a reason for closing its eyes to what the comparator tells us. The task is to paint as accurate a picture as possible of a normal industry rate of return, using the

best possible evidence, even if it is not perfect.

The second related point of principle is that the CMA should be asking itself whether the comparator says anything probative, and, sir, you will recollect those words. Again, that is *Hydrocortisone* paragraph 331.1.

The converse of that is of course that a comparator may say nothing probative, in which case the comparator can fairly be discarded, but short of that extreme position the CMA should be taking it into account. The President -- you raised a very good question yesterday which went to three related points. First, you asked whether we should be seeking to ascertain a reasonable rate of return for each individual product, including each strength. Second, you asked whether the reasonable rate of return should be product-specific or firm-wide, and third, whether the reasonable return should reflect the riskiness of the product.

Let me just try, have another go -- I am not disavowing anything I said yesterday, but these things are always clearer with a bit of overnight thought, so at the level of principle I want to address those questions and then we can explore how the answers play out on the evidence in a moment.

On the first question we say that the correct approach from a purist perspective is that the authority

should be attributing a reasonable rate of return to each individual product, including each strength of a product, but we are, of course, operating in the real world.

There is no single reasonable rate of return waiting magically in the ether to be discovered for this or for any other product. Identifying a reasonable rate of return is necessarily an approximate exercise insofar as it is based on empirical evidence.

So realistically one may well conclude that, for example, the reasonable rate of return for 50mg phenytoin capsules is the same as that for 100mg capsules.

THE PRESIDENT: That is simply because when a competitor who might be said to be comparable is publishing their accounting data you just do not get that sort of information with that sort of granularity --

MS STRATFORD: Yes.

THE PRESIDENT: -- they will have their returns based upon divisions rather than individual products --

MS STRATFORD: Yes.

THE PRESIDENT: -- and it may be more broad even than that. That is the problem that you face.

MS STRATFORD: That is certainly an important problem and I am going to come back to the implications of that for

what the CMA should, we say, have done.

As to the second question of whether one is looking for firm or product-specific rate of return, again, it will now be clear my submission is the correct answer of principle is that one is looking for a reasonable rate of return for the product under investigation, and it may be helpful to test that with perhaps an extreme example, but nonetheless a real example, of a global conglomerate that sells very diverse products ranging, let us say, from motorbikes to trumpets, and I am thinking of Yamaha.

Plainly, one is looking for the reasonable return on a specific product in that scenario, not for the entire undertaking, but again, we have to inject a dose of realism. The rate of return actually achieved across other companies' portfolios of products, especially if those companies sell similar products to the company under investigation, is likely to be valuable evidence of what a reasonable rate of return is for the individual product, and, as we will see, the Commission, in its *Aspen* decision looked at entire portfolios of products in order to calculate a reasonable rate of return for six specific cancer drugs. It did not seek to descend into individual product lines, no doubt in recognition that this was not a realistic exercise, and

the Tribunal applied the same approach in *Napp*, which just for your note is at {XN1/1/31}, I think, but of course that was many years earlier.

My answer to the third and final question on level of risk is much the same. In principle, we agree that one can take into account risk in determining a reasonable rate of return. In practice, the exercise is likely to be more messy, so one is unlikely to find a product which exactly matches the profile of the product under investigation, whether from a risk or from any other perspective, and we will see that is why in cases like *Aspen* and *Napp* the Commission or the Tribunal has not sought to carry out an exact matching exercise between individual products, but despite that it does bear emphasis in this context that Mr Williams, our industry expert, has deliberately crafted a cohort of comparator companies which do sell similar products to phenytoin, and an important point that we submit should not be glossed over here is this: if the CMA wishes to close its eyes to the actual returns earned by other companies unless it can be shown that those other companies sell products that are an exact or a very close match for phenytoin, then subject to constraints of proportionality, that is evidence that it would have to gather, and this is the point I have been trailing,

and I come to it squarely now.

It is not evidence that would ever be available to a company like Flynn, and again, Professor Waterson may remember that this came up at the last appeal where it was put to the CMA that it might have asked Flynn's margin comparators for some more information, but, as I will come on to explain, it has closed its ears to that advice, and I am going to come back to that.

Let me now come to the actual market evidence. The picture painted is that Flynn purchased its capsules from Pfizer and sold them on at a mark-up which is consistent with a normal industry margin, and the CMA does not really seriously dispute that as far as it goes, but says that it is an incomplete picture because it disregards the amount of absolute profits in pound terms earned by Flynn. I am going to also deal with that point, if I may, in this section of my submissions, but I will begin now with Flynn's other products.

Between us and the CMA, we have produced lots of charts, and they chop and change the comparisons in various ways, some of which look favourable to us, some more favourable to the CMA, and we are of course going to be debating this issue as part of the expert evidence, so I am not going to descend into detail now. I just wanted to show you, if I may, three charts which

between them paint at least an outline of the relevant picture.

The first is at {XE1/10/13}.

This is in CRA, Mr De Coninck's fifth report, and it is figure 1 there on that page, which shows the return on phenytoin expressed as a ROS, return on sales, compared to the rest of Flynn's portfolio.

The only point I am making at the moment is that it is fair to describe phenytoin as in the middle of the pack, and again, I do not think the CMA disputes that as far as it goes.

THE PRESIDENT: Yes, the return on sales, these are expressed as percentages and what you are saying is that phenytoin sits comfortably, or more or less comfortably in the middle of the returns?

MS STRATFORD: Yes. Over the page, if I may --

THE PRESIDENT: You have got some loss-making products as well.

MS STRATFORD: Yes. As pharmaceutical companies often have in their portfolio.

THE PRESIDENT: Yes. So I mean, that rather illustrates one of the dangers, and it is not a criticism, but one of the dangers of a portfolio metric. If you were to say: let us look at a portfolio of a comparator firm, you would have to bear in mind that because you are

looking at a product by product basis, the firm might have a reduced average because in its portfolio of products it has something like -- I am looking at Nebcin, which is, generally speaking, a loss maker, which would then reduce the average return.

MS STRATFORD: Yes. I do not dissent from that.

THE PRESIDENT: No.

MS STRATFORD: At the moment, I do not even need to try and make points based on the fact that there are some negative returns there. All I am doing, for the moment, is the rather more modest task of showing the Tribunal that phenytoin is somewhere in the middle, it certainly cannot be described as an outlier.

THE PRESIDENT: Yes.

PROFESSOR WATERSON: Just on this table, you have got me interested showing me a table --

MS STRATFORD: There are going to be more, never fear.

PROFESSOR WATERSON: You have got me interested showing me this table. I will not name particular drugs, but we can see that over time, sometimes some of them are -- well, one, which was already mentioned, was heavily loss-making, and then it moves to being reasonably profit-making. Do you know what the underlying reasons behind this movement is, to what extent is the firm able to rebalance its portfolio across products?

MS STRATFORD: I would be speculating if I try and give you an answer to that on my feet. It may be somewhere in the evidence, but if so, I am not aware. I do not even know whether Flynn minds me saying the name of the product, but you are talking about a product beginning with the letter N?

PROFESSOR WATERSON: Yes.

MS STRATFORD: I can take instructions on why. One can imagine -- this really is me speculating -- one can imagine within a portfolio that circumstances may change for particular products, and they may tip from being -- obviously if a company like Flynn thought that a product was loss-making and it was only going to get worse, then I am sure they are better business people than to necessarily continue, subject to patient and ethical concerns.

This is an aside now, but I think it is worth bearing in mind with phenytoin it was always expected -- and there is evidence on this -- to be a declining market --

PROFESSOR WATERSON: Yes.

MS STRATFORD: -- and it was also expected that there would be increasingly strong generic competition.

Now, we have the ironic situation where the reason that did not develop in the relevant period to the

extent it might have done may well have been -- almost certainly was due to the commencement of the CMA's investigation, so we have a slightly unusual arrested situation.

PROFESSOR WATERSON: I guess that is speculation, because we cannot know what the alternative might be.

MS STRATFORD: I think there may be some evidence on that. I think there is, actually, some factual evidence on that, but that in itself may be informed speculation from someone better placed than me to speculate.

THE PRESIDENT: To just broaden out Professor Waterson's question, though, to the range of return on sales, we see in all years here represented that the range is from something that is close to a doubling of price over cost, 88, 91, 90, to drugs that are significantly loss-making, minus 20, minus 36, we see the figures there.

MS STRATFORD: Yes.

THE PRESIDENT: Why does one have this range of pricing between different products? Now, again, I do not want you to speculate, but if there is material in the record to explain why that is the case, I think it would help us understand the significance of these figures.

MS STRATFORD: There is, and the CMA are going to make much of -- for example, as you may have seen in a lot of

these debates, they chop off certain products at the top and bottom, for example, and say for various reasons that those should not be taken into account, they were not typical, or there are strange things going on in relation to them. So I think can say, because it has been named anyway, the barbiturates at the top, for example, there are very particular circumstances there, and there is evidence -- this has been addressed by the experts, and I think it is probably not going to be fruitful or appropriate for me to start venturing into that now ahead of the evidence.

THE PRESIDENT: No. As long as we are going to gain further understanding, we are not fussy when.

MS STRATFORD: No, I am just trying to paint --

THE PRESIDENT: No, it is very helpful, Ms Stratford.

MS STRATFORD: -- an overall picture and obviously it is an overall picture from our perspective, no doubt Mr Holmes will have his opportunity to do that, but that is partly why I showed you -- when I showed you the chart of Flynn's other products, I did say: well, look, there is a lot of ink spilt here about the comparisons and which products should be in these charts and which accounting bases are used, and so on, and maybe we will have to -- or respectfully, the Tribunal will have to wrestle with some of the detail of that --

THE PRESIDENT: Of course.

MS STRATFORD: -- but it may be that we can step back a bit. I am sorry.

THE PRESIDENT: I suppose it is the stepping back which is why I am raising this question now, because one could, for instance, looking at these figures, say: well, look, we are going to take an average, or we will take the mode, we will slice these figures many different ways, and as you say, a great deal of ink has been spilt, but the way you slice them needs to be informed by why the figures are this way altogether.

So one has got -- we have discussed it, it is obvious -- a massive range, and, yes, you could take an average, but whether that is appropriate has to depend on why it is you have this range, and so in a sense we would be delighted to go down the different ways of slicing the figures and I am sure we could come up with variants on a theme which are novel, but when you are picking between different ways of doing it, you do need to understand why it is that returns are so different across products sold by the same undertaking in this case, and I am quite sure you would have similar figures elsewhere. We may not have them because they are confidential to third parties, but I am quite prepared to assume that Flynn is typical and not atypical in this

regard, and that may be an unsafe or safe assumption, but it is the reason for the range that we need to understand.

If one had, for instance, a 25% return across the board, it was just there with a deviation of a couple of percentage points here and there, well, then, we would be thinking: return on a drug, well, looks like it is about 25%, but here we have a massive choice, and why do we pick the average? Answer: I do not think we should be picking the average without an understanding of why it is you have this range.

It is a very broad question that I am putting to you.

MS STRATFORD: Yes. I fully take that on board. As I say, we are going to come to a lot of the detail in the expert evidence, but in my respectful submission, we should not lose sight here of why we are looking at this in the first place.

One of the purposes of this comparison, maybe the most important purpose, is to test the CMA's case that there is an industry-wide reasonable rate of return of 10%, so I think it is helpful to have that in mind.

THE PRESIDENT: Ms Stratford, it certainly is helpful, and I think the point I am making is neutral as regards the case that you are putting and the case that the CMA is

putting, because, we have not done the maths, but even if one were to compute an average of these five years and you were to come to a figure of 10% -- I have no idea whether you would or would not -- I am not sure why I would be that enthused in adopting it as an industry rate of return because of the deviation from the mean. So it cuts both ways. The range is troubling.

What you certainly can say is that the return of phenytoin is not an outlier. On these figures, that is a point you are perfectly entitled to make and you have made.

MS STRATFORD: That is the point I was making at the moment and maybe we can come back to the other implications of this.

Just to be clear, I referred to 10%, of course that is the ROCE --

THE PRESIDENT: Yes.

MS STRATFORD: -- and here we are looking at ROS, the implied --

THE PRESIDENT: We are.

MS STRATFORD: -- as you know, sir --

THE PRESIDENT: You are absolutely right.

MS STRATFORD: -- the implied ROS for a 10% ROCE is 2%, so that is where the CMA would have to get to.

I was then going to go over the page to figure 2

{XE1/10/14}. This is the beginning of some refinement, because here we see a chart with Flynn's other products with no promotion or amortisation costs, and the reason this was done was to respond to a point previously made by the CMA that some of Flynn's products had different investment profiles to phenytoin.

So this is one example where the pool of comparators has been limited here to products with low levels of capital investment, and that, sir, goes some way to meeting your point about trying to match the profile of products, comparator products, with phenytoin. So these are all products with lower levels of investment, and, therefore, everything else being equal, lower levels of risk because there is less capital at risk.

So all I say for now -- and I do not need to go further than this -- is it is an attempt to make the comparison an even closer one.

Then the final chart I wanted to look at for now on this point is at {XE6/4/13}. This is the CRA position paper, and it is figure 2 in the position paper. Dr De Coninck there has produced a new analysis inspired by the differentials analysis applied in the *Liothyronine* judgment.

So this is a table of excesses on Flynn's products based on the CMA's reasonable rate of return of a 10%

ROCE, and again, all -- I am doing something quite modest at the moment just saying phenytoin is in the middle of the pack.

As I say, the CMA, as we understand it, does not really take issue with these comparisons as far as they go, but they say the use of percentage margins masks the fact that phenytoin is an unusual product, and they say that for a combination of two reasons. One, it is a high supply price from Pfizer, and, secondly, high volumes, and the significance of that is that in combination, those features produce a high level of absolute returns.

I want to deal squarely, if I may, with that point. I would like to begin with two charts and the Tribunal might not have seen these because they feature less prominently in the expert evidence than some of the others. First, at {XE1/7/18}. This is in Dr De Coninck's second report, so prepared for the original appeal, it is figure 2 there. What it does is to show the unit costs of Flynn's portfolio in 2014 to 2015, so in other words, in the middle of the relevant period, and it is fair to say that phenytoin is at the upper end of the spectrum, but it does not have the highest costs, nor is it an outlier, so the CMA's contention that there is something very unusual about

phenytoin because of its input cost is wrong.

Second, still in the same report at page {XE1/7/24}, this is still CRA-2, at figure 5, this looks at the absolute returns on phenytoin per pack.

Again, I accept phenytoin is at the upper end of the spectrum, but it is nowhere near the most profitable product and is certainly not an outlier, and what these graphs show is that the level of absolute profits being earned by Flynn are being driven by volumes. It is not that the profit per pack is unusually high, but rather that Flynn sells quite a lot of packs. Although, to be clear, even in this respect, phenytoin is not unusual, Flynn has quite a few other products that sell in higher volumes, and we have set out the references at footnote 115 of our skeleton.

The CMA has not articulated any legal or economic reason why a company should be punished under the law of excessive pricing for selling more rather than fewer products, but we say there is an even more fundamental problem: how is one to distinguish, beyond a sniff test, between what is and is not an excessive amount of absolute profits, and it helps to --

THE PRESIDENT: Just so that I have this, what you are saying is that you have a marginal rate per pack which is in a range, and the way you are making your money is

by simply selling more at that marginal rate?

MS STRATFORD: I am submitting that what is particularly driving the level of absolute profits here -- and I am going to be quite candid about this, I am going to actually show you the figures in a way that quite remarkably one cannot get from the Decision -- it is the volumes that are really driving those profits.

So as I say, I want to put some concrete figures on the debate because we say it lays bare the problem. Flynn made absolute returns across all four strengths of phenytoin of around £8 million to £10 million per year over the relevant period. As we know, the CMA has chosen to pursue four separate infringements, one for each strength, so we need to look at the level of absolute profits for each of them, and therefore I am going to give the Tribunal some figures, and we do submit it is striking that despite hanging their decision in part on the amount of absolute profit that Flynn makes, neither the CMA nor Mr Harman have actually calculated how much money Flynn made on each of its strengths. So we have done the maths.

THE PRESIDENT: Do absolutely correct me if I have the wrong end of the stick here, because it is important that my understanding is right, but if one does the attribution of cost per unit sold correctly, in other words, if one

correctly allocates the fixed and variable, or direct and indirect depending on one's terminological preference, if one does that correctly in terms of the product under investigation, the fact that you are making more money on larger volume sales ought to be eliminated as a distraction.

MS STRATFORD: The reason I am -- sir, I apologise if I am not appreciating the sophistication of your question -- the reason I am going to this is because the CMA do put some weight, and it is not mere prejudice, there is a bit of prejudice, but they do put weight on absolute profits, and so I am dealing with that, and all I am doing here -- and it may be easier, there is a hand-up which I hope, again, may already have made its way to you, but if not we have hard copies. We gave this to my learned friends yesterday morning so they have had lots of time to think about it, but it really is not rocket science, any of this. (Handed).

This really does use the CMA's figures and assumptions, so I am not trying to do anything tricky here. They are fairly simple calculations. I am sorry, sir, shall I just give you a moment to read?

THE PRESIDENT: Yes, let us have a look at it, thank you.

(Pause)

Okay.

MS STRATFORD: Obviously these are total figures per year, so they are not per pack.

THE PRESIDENT: No.

MS STRATFORD: So in that sense, they do not control for volumes, but as I said, they are fairly simple calculations based on the CMA's own absolute profit figures and just broken down by strength, averaged across each year of the relevant period, and I stress using the CMA's own figures.

What they show is that Flynn made an average profit of, as you can see, around 1.1 million on the 25mg strength, 1.6 on 50mg, 3.5 on the 100mg and 2.6 on the 300mg, and we would submit, with respect, that these figures stated out loud do not immediately smack of excess, but the deeper problem is that the CMA has not put forward any economic or legal analysis or test to inform where the line should be drawn and, therefore, to answer the question, for example, of whether profit of 1.1 million per year on a generic drug is excessive or not.

THE PRESIDENT: This may be an indication for Mr Holmes to push back, because as I understand it what you are saying is this is an anticipatory attack on the CMA's case rather than the way you think things should be seen, but if we are right in looking at matters on a per

product basis then is not the analytical framework that we ought to be following an equation which is essentially unit price minus cost, minus return to get a gap between cost plus return which is the difference with price and then we ask ourselves is that gap excessive or not.

Now, one has, of course, a series of variables which we need to ascertain. Price, as I understand it, is uncontroversial, we have unit prices for all materials, and, as I understand it, but I will certainly be up for correction, we have a broadly agreed allocation of cost to each of the four different dosages of capsule that we are talking about.

So the real debate is how much do we slap on to the cost to constitute the return and then, when we have a figure, we can ask ourselves is that gap excessive or not.

Now, it may be, because one has problems with obtaining data, that in some cases, particularly for your comparators, one has to look at matters at a greater level of abstraction because you have just got the figures for a competitive undertaking and you do not have figures with this granularity. Well, of course we cannot expect you to produce material that you cannot produce and we will fiddle with it to get something

which is useable, the Tribunal is very used to doing that, but in terms of our direction of travel, is this cost plus return difference to price at the unit level what we ought to be looking at in terms of determining whether the gap between the two is or is not excessive as part of the limb 1 *United Brands* approach? If that is your position, then great.

MS STRATFORD: Yes.

THE PRESIDENT: If it is not the CMA's position then obviously we will hear from Mr Holmes and he can tell us why something different ought to be done, but I must say that is the way I see the terrain that we need to traverse, and it may be that we have to get data that does not fit very well in that terrain and use it carefully to make it fit, but that is a rather different question to the objective that we have in terms of determining excess.

If you are happy, then do say so; if you are not happy, then please do correct me.

MS STRATFORD: It is dangerous to answer these very important questions on my feet and without having turned round, but I think the answer is yes.

THE PRESIDENT: Of course, but if you want to tell me later that we are both chasing hares in the wrong direction then you tell us later.

MS STRATFORD: That is why I have been spending as long as I have, and I am afraid I am going to have to continue, I am very conscious that we need a break for the transcriber, but I am going to try and just get to the end of this section, if I can, which will be very soon. That is why I have been spending the time I have on the reasonable rate of return because it is difficult to overstate how important that is for the finding against Flynn in this Decision.

THE PRESIDENT: Well, because the margins are tighter in your case than they are, for example, in *Hydrocortisone* to take another example that you used last time.

MS STRATFORD: Absolutely.

THE PRESIDENT: So we have to tread more carefully on the rate of return. I mean, in *Hydrocortisone* we could say: look, the rate of return can be unbelievably generous, and on the approach we had there you still had an excess.

MS STRATFORD: Yes.

THE PRESIDENT: But as you have said, because of the high input price, it is a little bit more nuanced, or may be a little bit more nuanced, in this case.

MS STRATFORD: Just to conclude on what I have been saying about absolute profits, I have so far been talking about the returns in pound terms that Flynn actually made, and

I think it is helpful also in this context to have in mind the returns which the CMA contends Flynn should have made in the sense that they would not have been excessive, and I can take this quite quickly.

Just quickly to turn up a paragraph of the Decision at {XA1/1/228}, this is at paragraph 5.356 of the Decision, and we can see there that it says:

"The CMA's Cost Plus analysis includes a reasonable return for Flynn's Products of around £350,000 per annum [across all four strengths]."

Just to be clear about that figure, that is a reasonable rate of return based on Pfizer's actual input prices over the relevant period. I think the Tribunal already has this point, but if one adjusts that figure so that Pfizer's input prices reflect what the CMA says is its reasonable rate of return, the amount that is being put forward as a reasonable rate of return for Flynn, so by adding a 10% ROCE to its costs in that scenario, is the £66,000 per annum across all four strengths that I have already addressed you on.

I am going to leave aside whether any of these figures would be an adequate return for supplying a drug as a marketing authorisation holder, we say not, but for now what the figures undoubtedly show is that there is no objective method for drawing the line between an

excessive and non-excessive level of return in pound terms.

I am, I anticipate, going to explore this further with Mr Harman, so I will not say any more in opening, but it does bear emphasis that neither the CMA nor Mr Harman has any real answer to this point. We say they are applying their sniff test and nothing more.

I think that might be a convenient moment. I am making decent, not spectacular progress, but decent, so I may finish before lunch with a fair wind, as one euphemistically says, or I may tip over the short adjournment.

THE PRESIDENT: As I understand it, Mr Holmes has no concerns provided we have all of Thursday and we do, subject to a 4.15 stop, but that is the limit.

Can I before we rise just throw out one question which the more one gets into the detail on both sides, the more it troubles me not in the context of this case but in the context of competition law generally, and it is this: competition law really ought to be quite predictable, and if one needs wall-to-wall experts to say whether a price is or is not excessive, something may have gone wrong in that an enterprise out there that happens to be dominant will want to ensure that it avoids even the limb 1 *United Brands* test and wants to

avoid its prices being regarded as excessive so it does not have to debate the question of unfairness.

It would be a little unreasonable to expect any dominant undertaking to engage in an exercise of uncertainty as to what is and what is not an excessive price, and it does seem to me that we ought, as an outcome of this case, to have a test for excess that is capable of being applied at least in listing the relevant factors, to someone who does not have to go to all these very clever economists to explain whether their price is or is not excessive, and that is something which I think we would be wanting to move towards.

So in a sense it is an encouragement to the experts to not be too recondite in their assessment. Now that rather sounds like bolting the stable door after the horse has been cantering across many hills, and of course the case is what the case is, but it is something which I think we would want the advocates to bear in mind as something that is going to be wanting to inform our test for excess, simply because we would want a degree of market predictability, and I am not just talking about the pharmaceutical market, I am talking about any dominant undertaking faced with the situation where its prices are said to be excessive, I want

something which was a workable test going forward, and if I could encourage those who will be giving evidence to see the question in that light I think that would be helpful both for the outcome in this case and for the future.

I have no idea where that goes because I think the complexity sits in this courtroom, not on any particular side, but it is, I think, a concern.

MS STRATFORD: Thank you. That is certainly something we will bear in mind, and I venture to suggest is something we have borne in mind. I will just say two things very quickly. You may recall my slightly glib, possibly, mention yesterday of what happens when a company comes to me for advice, or any competition lawyer; that is a very good question in our submission. I was there making that point in the context of can it be right that so much of this question is loaded on to the CMA's discretion, but it is a point that applies to the issues you have just been elaborating, sir, as well.

The second point I would make is that we do, happily, have Mr Williams who I think it is fair to say alone of the experts is an industry expert, and he will be able to, and has already in writing in his reports, will be able to assist the Tribunal on how pharmaceutical companies in the real world approach

questions of pricing and, therefore, would approach any possible concerns about whether there might be excessiveness or anything of that sort, so I just plant that seed for now.

THE PRESIDENT: That is very helpful.

Thank you very much, Ms Stratford. It is midday. We will resume at 10-past.

(11.57 am)

(A short break)

(12.14 pm)

MS STRATFORD: Picking up very shortly the exchanges we were having just before the break, I think there is another way of putting it than I did, namely as a burden of proof point.

In our submission, it is important always to bear in mind that the CMA bears the burden of proving that Flynn's prices are excessive, and here it has now attempted to do that by applying a reasonable rate of return of 10% ROCE.

Now, it is entirely understandable, of course, that out of intellectual curiosity, the Tribunal may wish to consider what is a reasonable rate of return for phenytoin, but if the 10% ROCE is not a reasonable rate of return, then that should be, in our submission, the end of the appeal, because the CMA would not have proven

that Flynn's prices are excessive, and that is all I wanted to say on that.

THE PRESIDENT: Just so that you again have something to push back on, we have very well in mind the approach laid down by Lord Justice Green in the Court of Appeal in this case which is that where there is an appeal such as this, we will look first to see whether an error is a material error on the part of the CMA, and let us assume for sake of argument that this is a material error, and I am saying that without prejudice because I just want to get to the interesting question which is if you are right and there is a material error, you may be right that the Decision fails at that stage, but this would seem to me to be very much the sort of area where the Tribunal could remake the Decision on the basis of different data given the wealth of data that we have. So even assuming you are right on the material error point, I am not sure it ineluctably follows that there would be a holing below the waterline that would require the Decision to be effectively quashed for that reason, but that is something which is my immediate reaction to your point, and you may very well want to come back on that and say: no, that is simply not a course that on the facts of this case, whatever the theory, is open to the Tribunal to take.

MS STRATFORD: On my feet, reacting to that, on material error I was not intending by that to suggest that if it was 10.1% --

THE PRESIDENT: No.

MS STRATFORD: -- I am not going to get into figures --

THE PRESIDENT: No.

MS STRATFORD: -- but certainly I was not intending to suggest that some immaterial error --

THE PRESIDENT: No, what I am saying is let us assume you are right and they have it comprehensively wrong.

MS STRATFORD: Yes, then we do say that the appeal --

THE PRESIDENT: You say that is the end?

MS STRATFORD: -- must be allowed.

THE PRESIDENT: Okay.

MS STRATFORD: What then happens as a result of that is, with respect, a separate question, whether there needs to be, God forbid, another (inaudible) --

THE PRESIDENT: A further remission.

MS STRATFORD: -- or whether there can be some form of redetermination by the Tribunal. That is, in my respectful submission, a separate question --

THE PRESIDENT: Further down the line? I see, okay.

MS STRATFORD: I am going to come on to -- I have already trailed it a bit, but I am going to come back to the fact that because of the approach the CMA has taken

here, and it has not done the empirical exercise that we say it should have done, as a result, although we do have a lot of -- a bewildering, perhaps, amount of data and charts and so on, the CMA has not gathered data that we say would be needed, the empirical data that would be needed, and I am going to come on to that and why it was the CMA that needed to do it.

With that, sir, may I move on to Flynn's evidence about the rates of return achieved by other companies on the market, and again, I fully take account of the fact that it is going to be a topic of debate in the hot-tub and cross-examination, so I just want to introduce the parameters of the discussion at this point and focus on what we say is this particularly important legal question about the extent of the CMA's information-gathering duties, the point that I keep trailing and not dealing fully with.

The lay of the land on other companies' margins can be seen most easily from a table that is at {XE6/5/19}. This is the table at the end of Mr Williams' position paper, and the comparator companies identified by Mr Williams are listed, as you may already have seen, chronologically in the third column. The cohort has been refined with each of Mr Williams' reports up to his sixth report where he settles on what he considers to be

five particularly informative comparator companies, so that is Morningside, Aspire, Essential Pharma, Chemidex and Alliance. Just pausing there, we do say that is the strength of his evidence, as Mr Williams has responded constructively to all of the challenges and criticisms which the CMA have raised.

What pulls these companies together, if you like, is that they have certain features, and I will just list them. They are of similar size to Flynn, they are all English companies, none of them manufacture their own products, they all focus on generic or branded generic products, and all bar one of them supply AEDs, anti-epileptic drugs.

The references to the evidence on that, just for your note, are at paragraph 62 of our skeleton. That is {XL/2/27}. Again, this comes back, sir, to the President's point about seeking to derive a product-specific rate of return from real-world evidence. Mr Williams has deliberately chosen companies that sell similar products to phenytoin under similar conditions.

Now, I know he will be the first to accept that the comparison is not perfect, it never could be, but he has done the best that he and, importantly, any company in Flynn's position could do to approximate a normal

industry rate of return for a generic medicine like phenytoin, and looking back at the table -- sorry, I think we have gone on to the skeleton, but if we could go back to the table, please, at {XE6/5/19}, if we can maybe -- because it is quite dense, this table, I have actually got an enormous version of it for myself printed out, but if we could maybe zoom in on the bottom half of the table and looking particularly at the Williams 6 section, you can see there that the average ROS of these five companies was 34%, the average gross margin was 52%. Indeed, as we will see in the expert evidence, all of the empirical evidence speaks pretty much with one voice. The rates of return in the generics industry gravitate around the 20s and 30s per cent. You can see that quite simply by looking up the chart at the various iterations of Mr Williams' comparator cohorts which produce similar figures.

Mr Pascoe is helpfully reminding me, because I have asked the presenter to zoom in, the first column is gross margins and the second column, the second percentage, is ROS.

THE PRESIDENT: Thank you.

MS STRATFORD: The CMA does not factually dispute the return figures, nor could they, they are based on the companies' published accounts. Instead, their response,

and this is in their defence at {XB/9/113}, it is paragraph 263 of the defence, and the CMA says there that Mr Williams' refinements to his comparator set are not good enough, basically, because:

"... there is still a great deal of relevant information as to the comparability with Capsules missing."

The key controls which Mr Harman says are missing are the unit cost, ie the input price, and volumes, and we do, echoing what we were discussing before the break, we do say that one needs to step back here and inject a dose of realism.

Any company accused of excessive pricing will naturally look to comparator companies and will necessarily be limited to the publicly available information about those company's returns. Private companies, of course, cannot ask their competitors for product by product information, such as their costs and their market volumes. That simply is not information that would ever be available to a company accused of excessive pricing.

As soon as it attempts to go past portfolio level returns, coming back to the point, sir, that you were putting this morning, the company will hit a brick wall, and it follows, in our submission, that if the CMA says

that it is unable to assess a comparator because of missing information, that is information which subject to the constraints of proportionality it, the CMA, must go and get.

Now, in this case, there are no proportionality objections, no valid proportionality objections. We have served up five comparator companies on a plate. The CMA could very easily have asked: one, which products do you have with a unit cost over X pounds; two, which products do you have with volumes over Y; and three, what are your returns on those products? That would, with respect, have been a simple exercise, and this is a partial answer, again, to the President's question about the level of granularity at which the CMA should be calculating the reasonable rate of return.

So, yes, in a perfect world, one would be seeking a comparator that perfectly matched the features of phenytoin and operated in an effectively competitive market, but in the real world, that is an impossible task and one cannot even get close to it unless, and this is the important point for the moment, unless the regulator obtains the necessary information from the comparator companies that are put forward to it, and that is, responding to what the CMA have said in their skeleton -- this is paragraph 82(b) of their skeleton,

we do not need to get it up -- this is poles apart from asking the CMA to carry out a whole market survey or anything of that sort.

It would not involve the CMA having to consider, as they suggest the price, costs, volumes, risks, activities and competitive conditions inherent in the supply of, and I quote "hundreds of products". That just is not right.

Now, this point about missing information is not a new point, it has not been conjured up for the purposes of this appeal. We have asked the CMA to obtain further information about these comparators repeatedly, and I am just going to take two examples, if I may.

First, if we could go to bundle {XM/20/29}. This is the transcript from Day 9 of the original appeal, and page 27 there. I do not know whether you would be able to swiftly review from line 9 on page 27 down to line 12 on the next page, page 28.

THE PRESIDENT: We will look at that now.

(Pause) Yes, thank you.

MS STRATFORD: Sorry, just one moment. I am not sure whether I have a reference ... I am sorry, I think because of the difference between the internal page numbering on the transcript, it is internal page 27,

bundle page {XM/20/29}, I am sorry.

THE PRESIDENT: No, that seemed a rather helpful passage, I must say.

MS STRATFORD: Yes, it is all very interesting stuff. We could spend ages on this.

THE PRESIDENT: Every misreference has a silver lining.

MS STRATFORD: So it is page {XM/20/29}. I am sorry if I mis-spoke on the Opus reference.

THE PRESIDENT: Not at all. So line 9 through to line 12?

MS STRATFORD: Line 12 on the next page, because this is Professor Waterson, so you can immediately see why I particularly want to look at these paragraphs or these passages, I should say. (Pause)

So Professor Waterson therefore put it to Mr Harman that if the CMA felt it needed detailed comparisons between individual product lines that is not something that a company accused of excessive pricing could get, but it might be something the CMA could get by using its statutory powers, and for your reference, I will not take up time going to it, but the same point was raised at transcript Day 8 pages 98 to 99. The Opus reference for that is {XM/19/100}, and that is where Mr Harman -- Professor Waterson may even recall this -- Mr Harman accepted that it would have been useful to have had the missing information from the CMA, but as an expert

providing an opinion ex post facto, he had to work with the evidence he had been given.

If we could then go, my second example, to Flynn's remittal response to the statement of objections at the remittal stage, this is {XA1/6/49} and paragraph 7.34. This paragraph is making the point that Mr Williams' comparator analysis is similar to that carried out by the Commission in *Aspen*, and I will come back to *Aspen* in a moment, but on the point that I am currently on, you can see that it says:

"If the CMA considers that the approach in *Aspen* is inappropriate, at the very least the CMA should have undertaken further factual enquiries in relation to Flynn's comparator companies to ensure relevant information was available. Flynn is not able to obtain detailed data from such companies. It is only the CMA that has the powers to be able to obtain more detailed information as to these comparators."

So I just wanted to show the Tribunal that the CMA has been on notice throughout its investigations that if it felt it needed to lift the lid on Flynn's company comparators and seek to match individual product lines with phenytoin, that is something it had to do itself, and its refusal to do so, we say, is of a piece with its general approach of closing its eyes to the real world,

and it has caused real procedural unfairness to Flynn.

I keep saying that I will return to the Commission's decision in *Aspen*. I would like to come to it now. It was a Commission decision resulting in commitments which found that Aspen had charged excessive prices for six cancer drugs, and just by way of introduction, we rely on it for two points.

First, for the figures which the Commission alighted upon as a reasonable rate of return, which are of a piece with the figures produced by Mr Williams' comparators, and conversely and importantly, bear no relation or no resemblance to the CMA's figures.

Second, we rely on *Aspen* for the method that the Commission used to identify comparators which Mr Williams has essentially mirrored, and *Aspen* is at {XN6/7} and I want to go to pages {XN6/7/25-26}, please.

So looking to start with at recital 129 towards the bottom of page {XN6/7/25}, what the Commission did was to identify all companies which satisfied two tests. One, they generated substantial revenues through off-patent products, so the threshold here was for more than €1 million and 70% of revenue, the detail of that does not matter, and second, they included substantial sales of drugs in the same category as Aspen's cancer drugs, more than €100,000.

Moving on, one sees at the next recital, 130, that the Commission took those companies and calculated their returns on an EBITDA and a gross margin basis. It used two accounting bases.

Then at 131, the Commission records a median gross margin of 54% and a median EBITDA of 23% based on its cohort of comparators.

Pausing there, this is a very different benchmark to the CMA's benchmark in this case which is designed to cover Flynn's economic costs and no more, so it is a benchmark based on actual market data of the kind that Professor Waterson and his colleagues envisaged in their original judgment.

It is also importantly a high level portfolio-based approach. The Commission does not seek to look at the individual product lines of the comparator companies or to match their products with the profiles of the particular six cancer drugs under investigation which is the opposite of the approach now being put forward by the CMA, and that is why I mentioned the *Aspen* decision yesterday, you may recollect, in response to the President's question about the level of granularity at which one tries to calculate a reasonable rate of return.

Where the Commission came out at, and we perhaps can

go forward now to page {XN6/7/44} of this tab just to see where the Commission got to at recital 239. The Commission was prepared to accept Aspen's commitment to charge prices that were within a range of 10% to 20% of the median market returns, and that means that it considered returns of 30% to 36% EBITDA to be non-excessive.

In case you want it for your note, the calculations to track that through are set out in CRA-6, paragraphs 80 to 83. That is at {XE1/11/28}, but I am not going to take up time with that. What we say is that this analysis, both in terms of the approach and the actual figures, does support Flynn's analysis and fundamentally differs from that of the CMA.

Finally on comparators, we do also rely on the margins of tablets. For convenience, since I am going to address tablet pricing in my final section as a freestanding topic, I will come back to that, if I may, but I do flag here that tablets have some relevance to the limb 1 analysis as well as limb 2.

The final point under my section 4 that I wanted to deal with is cross-checks and relatedly the scale of Flynn's alleged excesses, and given the limited time available I am going to take this quickly and return to these issues as appropriate in closing. I just want to

make five headline points for now.

First, the CMA has put forward as a cross-check a 6% ROS rate. I already have showed the Tribunal that this is the only alternative rate of return used in the Decision. Professor Waterson in particular will recall the Tribunal already rejected the CMA's case based on that benchmark, and we do say that if it had been a good benchmark, there is no reason why the findings in the original Decision on excessiveness would have been set aside.

Second, having been rejected as a primary benchmark, the CMA cannot redeploy the 6% ROS rate as a cross-check: a rate of return which is no good as a primary benchmark is no better as a secondary one.

Third, once the 6% ROS rate is dispensed with, the Tribunal faces a stark choice between a 10% ROCE benchmark, which is based on theory alone as we have seen, or a ROS benchmark which is based on real world comparators.

As I have explained, the Tribunal had already put that debate to bed in its original judgment, but the CMA is seeking to have another go in its remittal decision and before this Tribunal.

Fourth, once the real-world returns figures are plugged into the equation, Flynn's excesses become

minimal to non-existent. I am not going to go through the figures now, and again, just for your note and for reference the calculations are set out at paragraph 49 of Mr Williams' position paper. That is at {XE6/5/16}.

Fifth and finally on this, there are a couple of other places in the Decision where the CMA has rerun its ROCE analysis using different assumptions, and there are three, just to give them to you.

First, it posits an increased stock value based on the evidence given by Mr David Walters, Flynn's witness at the first appeal, resulting in an increase from £2.8 million to £5 million, and for your note that is at Harman 3, Mr Harman's third report, paragraphs 4.4.7 to 4.4.8, which is at {XE1/15/39}. So that is the first.

Second, the CMA considers in passing increased WACC of 31% which is implied from its 6% ROS benchmark, so rather than its baseline 10% WACC rate. That is Mr Harman, third report, paragraph 4.5.12 at {XE1/15/42}.

I can say immediately neither of those two exercises resulted in substantial changes to Flynn's excesses, and that is the point that Mr Harman makes at 4.5.12 of his report.

Third, Mr Harman reruns the ROCE analysis based on capital bases which are variously 1.5 times, 2 times and

3 times Flynn's actual capital base. Again, the calculations, unsurprisingly, produce materially the same level of excess, that is paragraph 4.5.14 of Mr Harman's report. But the short answer to all of this is that ROCE is a bad metric for an asset-light company such as Flynn because it is not capable of distinguishing between excessive and non-excessive returns, and we submit that changing the parameters of a bad ROCE analysis does not somehow magically turn it into a good analysis. So these calculations, therefore, do not provide any support for the CMA's primary benchmark of a 10% ROCE.

That is the end of my section 4, you may be happy to hear. I turn finally to my fifth section and to tablets.

Now, rather as I did at the start of my opening, I want to stress that the fact I am coming to this last and more shortly says nothing about its importance, it is just that I am trying to avoid or at least minimise duplication with what Mr Brealey has already covered.

It is common ground that Flynn benchmarked its prices for capsules at a discount to the drug tariff price of phenytoin tablets. That is the explanation for Flynn's pricing. It did not price as high as it possibly could, it chose to price by reference to the

published price of tablets which was the only publicly available benchmark since tablet ASPs were confidential.

I want to be clear as to what Flynn's case is in respect of the tablet comparator, not least because it has been said against us that our arguments relying on the phenytoin tablet are unclear. That is said in the CMA's defence at paragraph -- there is no need to go to it -- 367.2.

Flynn submits that the relevant benchmark for the purpose of assessing whether Flynn's prices were excessive or unfair is the drug tariff price of tablets, and that is for three reasons.

First, the drug tariff price was the product of intervention and ultimately agreement on the part of the Department of Health. The DH intervened to bring the price back down to a level that it considered reflected tablets' economic value. That fact alone sets this case apart from the other excessive pricing appeals.

One of the questions which the Tribunal had for Mr Brealey on Monday was whether the drug tariff price for tablets is less a comparator price and more a price control. If it is helpful that is at {Day1LH1/111:3-5}. The answer, in my submission, is that whether one describes the drug tariff price for tablets as a price control or a price comparator is perhaps of little

consequence. The nomenclature which one adopts does not alter the substance or the force of the point which the appellants make. The point we make is that the drug tariff price reflected the price which the Department agreed to pay, indeed insisted on paying, for a clinically identical product.

The appellants were, therefore, justified in benchmarking at a discount to that price. So in the language of the *United Brands* test, the appellants' prices were not, and I quote, "unfair when compared" with the drug tariff price of the tablet which is a comparator product. That is, as you know, 252 of *United Brands*. Or alternatively if the drug tariff price is described as a "price control", the appellants' prices were plainly not unfair either in themselves or by comparison with other products when it has considered that their prices were consistent with what I will call the controlled price of the phenytoin tablet.

Either way, the result is the same, and it was recognised of course in *United Brands* that other ways may be devised of selecting the rules for determining whether the price of a product is unfair. That is paragraph 253.

The identification of a controlled price for a clinically identical product is in my submission

plainly another way of illustrating that a price is not unfair. That is my first point.

The second of my three reasons is that the drug tariff price reflects the price which the Department of Health actually pays for phenytoin products, and in this respect the Department of Health is the relevant consumer of those products in the sense that it pays the price for the drug. The CMA's complaint as can be seen from their CCG witnesses is that the Department had to pay too much for phenytoin capsules.

The prices charged at intermediate points in the tablet supply chain, so the ASPs, are in one sense -- and I do not put it higher than that -- but in one sense they are neither here nor there. None of those prices had any effect on the end price paid by the Department of Health, they simply determined who gets what slice of the pie within the supply chain.

On this, it might be helpful to go briefly, if we could, to {XL/3/20} which is the CMA's skeleton, and there is a graph below paragraph 33 is what I wanted to look at on this. This is really coming back to the President's point on Monday, looked at in a different graph. The gap that one can see between the drug tariff price for tablets, so that is the purple line, and tablet ASPs was to the benefit of wholesalers and

pharmacies who took a comparatively larger slice of the price paid by the Department of Health as the gap opened up. Whether any individual tablet supplier received more or less of the pie did not alter the overall size of the pie for the Department.

So it is, in our submission, helpful to keep in mind fairly firmly this is not a case where Flynn has been accused of pricing in a way that squeezed out intermediaries or anything of that sort, intermediaries in the supply chain, the wholesalers or the pharmacies. The complaint relates to the end price paid by the Department which is the body that made the complaint to the CMA.

My third point on this is that the drug tariff price is the only tablet price which was known to Flynn at the time it launched capsules, and I know I have made that point several times now, and in a sense it is an obvious point, but I do respectfully submit it bears repeating: Flynn could not have known the ASPs charged by tablet suppliers, which were confidential, and Mr Williams explains in his report, and no doubt this will be expanded in the teach-in and the hot-tub and so on, that for this very reason benchmarking prices to the drug tariff price of similar medicines is standard practice in this industry, and some of the contemporaneous

documents that Mr Brealey took you to on Monday corroborate that.

That evidence goes some way to responding to the Tribunal's question before the hearing about the maximum theoretical price for a drug, because one practical constraint is that drug manufacturers do not price in a vacuum; they do so by reference to the published prices, namely the drug tariff prices, of other medicines. That is what happened in this case.

So Flynn did not try to push the price as high as it could possibly go, which is a point of distinction from cases like *Liothyronine*. It used a benchmark which was the DT price for tablets. Flynn's position is, therefore, that the primary comparator to which the Tribunal should refer when assessing Flynn's prices is the drug tariff price of tablets.

I am going to come on to deal with what the CMA argues. I do not know whether you would prefer me to stop now, I am conscious we are nearly at 1.00. I have not got a great deal more to cover, but I am in your hands.

THE PRESIDENT: It does not seem to me to make sense for you to start and then stop three minutes later.

MS STRATFORD: It is not going to be three minutes. I do not want to overpromise.

THE PRESIDENT: No, no, that is what I mean.

MS STRATFORD: Oh, I see.

THE PRESIDENT: We would have three minutes. Why do we not resume at 2.00.

MS STRATFORD: I am grateful.

THE PRESIDENT: Very good.

(12.57 pm)

(The short adjournment)

(2.04 pm)

THE PRESIDENT: Ms Stratford, before you resume I have one completely irrelevant piece of housekeeping. We have identified a proximity card by the lifts. It certainly does not belong to any of us, but if it belongs to anyone in court, well, I have it here and I will make sure it is given to someone responsible who will look after it pending claim. So we have it here.

MS STRATFORD: That is very kind. No one is immediately recognising it, but that is extremely thoughtful.

THE PRESIDENT: No worries.

MS STRATFORD: Thank you.

I am going to come now, obviously I am on my final section, I am on tablets, and I had made my submissions as to why the primary comparator to which the Tribunal should refer when assessing Flynn's prices is the drug tariff price of tablets, and I am now going to briefly

address the reasons why the CMA argues that the drug tariff price is not a reliable comparator, and it says there are three reasons. I just want to deal with each of those briefly.

The three reasons are, first, the CMA states that tablets and capsules are not like for like, because the DT price, the drug tariff price, is the price at which the NHS reimburses pharmacies for medicine, whereas of course Flynn is further upstream in the supply chain, and its selling prices are further up in the supply chain. That is paragraph 6.192.1 of the Decision, no need to go to it unless you want to at {XA1/1/290}.

Second, the CMA contends that £30 did not reflect the price which the Department of Health had accepted to be the value of tablets and was willing to pay, that is 6.192.3. Again, no need to go to it, although I see it is coming up on the screen {XA1/1/291}.

Third, the CMA argues that the DT price cannot be a reflection of the economic value of the product because the tablet market was not sufficiently competitive at the time it was agreed, and on that third point, Mr Brealey has said all I want to say on that issue in opening, so I am not going to deal with that, and I am just going to address briefly the first two points.

As to the first point, as I have explained, Flynn benchmarked its prices at a discount to the drug tariff price of tablets accounting for its position in the supply chain, as nearly all companies in the industry do.

So Flynn's list price, as we have already seen, for a pack of 84 100mg capsules was £67.50. That is in particular apparent from figure 2.6 of the Decision. That equated to a 25% discount to the drug tariff price of phenytoin tablets of equivalent number and strength, and again, just for your note, if you wanted the reference, Williams 6 at paragraph 21 deals with that at {XE2/6/6}, but no need to go to that now.

Flynn then applied further discounts, it is perhaps important to remember, when selling to wholesalers and pharmacists, and again, no need to go to it now, but that is Mr Fakes' witness statement at paragraph 85 {XC1/1/36}.

So there is, we say, nothing in the CMA's reliance on Flynn's position in the supply chain as a basis for rejecting the drug tariff price as a relevant comparator. Nevertheless, the CMA has persisted with this point in its skeleton and in particular I just want to pick up a point that they make at paragraph 46 where you will recollect they say, and maybe it is worth just

having this in front of you, it is at {XL/3/23}, the CMA says that Flynn set its prices for 25mg capsules and 50mg capsules above the tablet's DT price on a pro rata basis, and they say, the CMA, that Flynn has offered no explanation for this.

I just wanted to point out that is not correct. Mr Williams explained that it is normal for a company to add a premium to the price of lower strength products, and again, for your note that is Mr Williams' sixth report at paragraph 36, bundle reference {XE2/6/10}. I think that must be XE1.

Self-evidently lower strength products -- sorry, it is XE2. Mr Williams has his own -- how could I forget? -- he has his own special bundle all to himself.

The point I wanted to make is that lower strength products may have proportionately higher costs.

Turning to the CMA's second point as to whether the DH was satisfied with the price that it agreed with Teva, the CMA does not contest the appellants' account of what was in fact as a matter of fact said in the Department of Health's meeting with Teva. If needed, a reference for that is the CMA's defence at paragraph 69, again, no need to go to it, but that is {XB/9/28}.

Mr Brealey, of course, has already taken the Tribunal through the evidence relating to the intervention and the subsequent agreement, and I am certainly not going to repeat any of that. I just want to make two high level points, if I may.

First, there is no representative from the Department of Health who Flynn can cross-examine, and that is troubling given that in the original appeals, the Tribunal noted the unfortunate absence of witness evidence from the Department of Health given -- and I am quoting now from the original judgment at paragraph 82:

"... given the undoubted relevance of the DH's role to the matters in issue..."

The Tribunal is, therefore, left in a rather unsatisfactory position of having to do the best it can on the basis of the limited documentary evidence that there is.

Given the very legitimate question marks which hang over why the price remained as it did until 2016, we submit that the benefit of any doubt must be given to Flynn, and if I need authority for that we point to the decision in Napp at paragraph 109, and for the transcript that is at {XN1/1/31}.

For the Department simply to repeatedly say after the event that it was not happy with the tablet price

and that it was an oversight, to use their word, a word, I might say, that they came up with in 2020, is not good enough.

Second, in its skeleton the CMA says that a buyer's willingness to pay is not an indicator of economic value. Now, to be clear, that is not our case. Flynn's position is that the drug tariff price was the product of direct intervention by the Department which resulted if an agreement on a price. The £30 price did not come out of thin air, it was insisted upon by the Department as reflecting the value of tablets, the very word used in the email after the meeting that Mr Brealey took the Tribunal to.

Third, virtually all of the evidence on which the appellants now rely, and which Mr Brealey took you to on Monday, has come to light since the first appeals. So the CMA is wrong to say that there is no basis for a different conclusion to the Tribunal's conclusion last time around regarding whether and for how long the Department was satisfied with the £30 drug tariff price of tablets. That is what it says at paragraph 43(c)(i) of its skeleton. Again, Mr Brealey took you through the new documents on Monday.

For those reasons, Flynn's primary position is that the appropriate benchmark for capsules is the drug

tariff price for tablets, but an examination of tablet ASPs, which is what I am going to come to now, does reinforce the absurdity -- and I use that word advisedly -- of the CMA's proposed reasonable rate of return for Flynn.

Flynn's economic expert, Dr De Coninck, has calculated the price for phenytoin capsules under the CMA's reasonable rate of return which of course is supposed to be based on normal competition, and for the purpose of calculating this price, Dr De Coninck took the CMA's proposed cost plus figures for Flynn and the CMA's proposed cost plus figures for Pfizer, and he added these figures together to calculate the price which reflects each company's reasonable rate of return under the Decision, and the price he gets to per capsule is 8 pence. You may have seen that, it is in Dr De Coninck's sixth report at paragraph 115. That is at {XE1/11/40}.

What Dr De Coninck has done is to compare the 8 pence to the ASP of tablets during the most intensely competitive period which, as we know, is so-called period 3 from September 2012 to July 2014, and the comparison is, therefore, between 8 pence and 43 pence, which is the ASP for tablets.

So this means that Flynn has been found guilty of

abusive behaviour for charging a price above a threshold, 8 pence, 8 pence per capsule, that is only a fraction of that which other companies charged for a, we say, materially, certainly clinically identical product, and this is not a marginal difference: assuming the tablet market was even remotely competitive, the CMA has got its benchmark wrong by several orders of magnitude.

I should mention that this extreme differential between the CMA's cost plus figure and the actual prices achieved in the tablet market, one can see it represented graphically in the graph that Mr Brealey referred to on Monday which he handed up, and you will recollect there the dotted pink line at the bottom which represents the CMA's cost plus figure, ie what it considers to be a reasonable rate of return.

The CMA has no real answer to this point. It is not addressed in the defence. I refer in particular to defence paragraph 391, again, this is just for your note. It is not addressed in the CMA's skeleton. The closest they come to it is footnote 92 of the CMA's skeleton which, again, for your note is at {XL/3/30}, and it simply asserts that our point takes Flynn no further without providing reasoning to support that bald assertion. The point is reinforced, we say, when one

compares the margins of tablet suppliers and Flynn's margins.

Dr De Coninck has conducted precisely that analysis. He has compared Flynn's margins on capsules and the margins of tablet suppliers during the most competitive period in the tablet market.

If we could -- I think it would be useful to go at this point to the fifth CRA report which is at {XE1/10} starting at page {XE1/10/27}. Sorry, if we can go to page {XE1/10/28}, I really want to look at the figures in table 4 on page {XE1/10/28} and particularly the third line there.

I should say there are various confidentiality markings here. It may be helpful to mention my understanding is that Accord's information should no longer be marked as confidential, but we understand Teva continues to assert confidentiality, and that has been accepted by the CMA.

I can see people looking -- anyway, I am told that is the case.

THE PRESIDENT: Well, we will look at them but not mention them.

MS STRATFORD: Flynn's margin, one can see from the first column, was 29.7%, which was significantly lower than the margins of Wockhardt, 72.3%, the Teva figure which

I will not state and Accord I was going to state but you can read it for yourselves, thank you. That comparison shows Flynn's margins were far below that of the tablet providers operating in sufficiently competitive conditions.

Flynn, I should say, does not have access to and the CMA has not obtained data regarding Milpharm's costs, the data that would be necessary to conduct a similar margin calculation for Milpharm, and for your note there is a reference to that in CRA's fifth report at paragraph 72 which is at {XE1/10/27}.

Clearly that cannot be held against Flynn: it was for the CMA, not Flynn, to obtain relevant data which would have enabled it to properly compare Flynn's prices or margins with those of tablet suppliers during the relevant period.

I have already made the point that the CMA, not Flynn, holds the power to request such data from third parties. The CMA's failure to obtain it is, we say, all the more problematic in circumstances where even the CMA itself now agrees in its skeleton that the tablet is a potential benchmark. The CMA says that at paragraph 37 of its skeleton.

PROFESSOR WATERSON: You may not know the answer to this but one thing that strikes me here is the big difference

in -- I will not mention either of the figures, but the big difference in costs as between Teva, Wockhardt, which are about the same, and Accord. Is there a reason for that, do you know?

MS STRATFORD: I am instructed that Accord purchased, as far as we understand, from Wockhardt and also from Milpharm.

PROFESSOR WATERSON: Right, okay.

MS STRATFORD: I am afraid I cannot assist further on that at the moment.

PROFESSOR WATERSON: No.

MR HOLMES: Sir, if it helps, they represented a very, very small proportion of the market, I understand about 1%.

MS STRATFORD: Yes.

PROFESSOR WATERSON: Okay, thank you.

MS STRATFORD: Yes. But nonetheless, they were in the market, and they had their prices.

You will appreciate where this submission goes, is that in these circumstances, the CMA's duty to fairly evaluate the comparators put forward by the appellants is an important one, particularly given the quasi-criminal nature of what is in issue.

In its skeleton, the CMA contends that Dr De Coninck's tablet margin comparison is unreliable because the comparators had different risk profiles and business models to Flynn. This is in particular CMA's

skeleton paragraph 67(c) at {XL/3/31}, and this is me now meeting some of the sorts of points that Mr Holmes was just interjecting, but our submission is that the CMA ignore important similarities between the tablet manufacturers on the one hand and Flynn, between their business models, so taking Accord to start with -- and I accept they were not a major player in volume terms in the market, but it is, in our submission, a good margin comparator because, like Flynn, its role was limited to the supply and not the manufacture of tablets. So Accord had a similar business model to Flynn, it was dependent on a third party or third parties for manufacturing, and Dr De Coninck discusses that at paragraphs 140 to 141 of his seventh report.

Similarly, Wockhardt, Wockhardt UK's supply chain, mirrored that of Flynn. Wockhardt UK was itself a marketing authorisation holder for tablets, but it relied upon a third party to manufacture the tablet product. Again, for your note, you get that from CRA's fifth report at paragraph 71, also Wockhardt's response to a section 26 notice served on it on 18 September 2020 at paragraph 7, and for your note, that is at {XH/136/2}, a company called Custom Pharmaceuticals manufactured for Wockhardt.

In addition to comparing Flynn's percentage margins

with those of tablet suppliers, Dr De Coninck compared Flynn's absolute profit per 84-capsule pack to that of tablet suppliers, and his findings on that, which again, there is some confidential material here, that is in CRA's seventh report at {XE1/12/45}, and I want to look in particular at table 9 on that page. Sorry, it is back to the same table, but I am coming back now to not the margins but the actual figures.

THE PRESIDENT: Yes.

MS STRATFORD: So what Dr De Coninck finds is that Flynn's absolute return was below those of tablet suppliers during period 3. You can see there Flynn's average margin in absolute terms, £17.30; Wockhardt, £26.65; Teva's, I will not read out, and Accord UK's, again, I will not read out.

That is a further basis upon which the Tribunal can satisfy itself that Flynn's prices were not unfair by comparison with the closest conceivable comparator, the phenytoin tablet.

It is also, we submit, rather telling that the CMA has not even attempted to calculate the ROCE rates of the tablet suppliers. Given those suppliers' ROS rates, it is reasonable to assume they are much higher than the CMA's 10% reasonable rate of return, but we do not know because the CMA has not chosen to check, and that is not

something we can do.

Finally, the CMA has not answered the point that if tablet ASPs were taken as the relevant benchmark, Flynn would stand accused of excessive pricing for having failed to sell at a loss because unless it sold at or below the price that Pfizer charged to it, which as we have discussed is to be and has been taken as a given part of Flynn's cost stack, it would necessarily exceed the tablet ASPs. Dr De Coninck sets out the maths behind this point at paragraph 133 of his seventh report, again, there is no need to go to it now unless you want to. I am grateful.

Before rounding off my submissions on tablets, I want to acknowledge the Tribunal's question of yesterday about whether there is any evidence showing the correlation between price and unit cost, not just in the pharmaceutical industry but generally speaking, so how far prices in the real world track costs. In case helpful, that is in the transcript {Day2LH1/59:9-15}.

Now, as it happens, Dr De Coninck has addressed that question in his sixth report at paragraph 94. That is {XE1/11/32}. I am just mentioning it because it may be a point that the Tribunal wishes to address as part of the hot-tub. I was not going to make submissions on it, it is there, it is what it is, I am not saying it is

extensive discussion, but it is addressing what I understood to be precisely the question that was being raised.

THE PRESIDENT: Well, that is very helpful, Ms Stratford, thank you.

MS STRATFORD: Thank you.

So to conclude on tablets and to conclude my opening submissions, we say that the appropriate benchmark was the drug tariff price, since that was the price actually paid by the NHS, and the only price known to Flynn and Pfizer.

Alternatively, if contrary to that one does look at ASPs, we say they are exculpatory for three reasons. First, they show that the CMA's analysis, in particular of excessiveness, is divorced from reality, so its benchmark would involve Flynn selling capsules at a fraction of the selling price of tablets under competitive conditions. Second, Flynn's margins and absolute profits compare favourably to those of tablet suppliers, and third, the important benchmark for the purposes of this appeal is the end price paid by the Department of Health rather than the prices charged by each person in the supply chain to the next, and that is the point I started with.

So, sir, unless I can assist the Tribunal further,

those are my opening submissions for Flynn.

THE PRESIDENT: Ms Stratford, thank you very much. We are very much obliged to you. Thank you. Mr Holmes.

Opening submissions by MR HOLMES

MR HOLMES: Thank you, sir. There might need to be a little bit of rearrangement of the furniture. It is rather like Cape Canaveral, the experience on the --

THE PRESIDENT: Would it help if we rose for five minutes to do the re-arranging?

MR HOLMES: I do not think that is necessary, sir. It just might take moment a moment to get a lecturn set up.

Very good. So good afternoon, sir, members of the Tribunal. I propose to structure my submissions as follows: I will begin with some immediate responsive submissions to what my learned friends have said. I will not attempt to address every point that my learned friend Ms Stratford has raised. It was obviously a very dense presentation that you have heard this afternoon. Some of the points will be met in the evidence when the material is explored with witnesses, but I will try and give you some headline reactions on the main lines of the case. I will then turn to the relevant factual context, and I want to focus here on the conduct which is at the root of this case.

We say that this is important when considering some

of the arguments that you have heard, it is relevant to the fairness of the parties' pricing, and it is also important to understand the arrangements that were in place when assessing some of the proposed comparators that are relied on by the parties.

The Tribunal will have seen the findings made by the Tribunal in the first appeal about those arrangements, it is perhaps worth quickly turning them up. They are pithily recorded in paragraph 457 of the first phenytoin judgment which is at {N1/2/143}. You see at paragraph 457 at the foot of the page, if we could blow that up, please, the Tribunal's conclusion that:

"... the evidence consistently showed that the strategy, which was jointly evolved between Pfizer and Flynn, to remove ... capsules from the PPRS and to price them at a much higher level (close to the then Drug Tariff Price of tablets), was based on a clear-sighted view, by both, of the increased profit that would flow to each from that arrangement: indeed that was the admitted purpose. Pfizer and Flynn ... discussed a percentage split of that benefit, ultimately reaching a commercial solution based on a supply price which provided each with a satisfactory share of the increased profit. They did so, irrespective of the fact that Flynn was left free as a matter of contract law to

determine precisely what price (above the Pfizer supply price and appropriate other costs) it actually set. Pricing was an integral part of the strategy radically to improve the profitability of the capsules."

I would like to show you the contemporaneous documents which underlay those findings, and also --

THE PRESIDENT: Pausing there, though.

MR HOLMES: Of course.

THE PRESIDENT: Is 457 postulating some kind of linkage between the separate stages of the supply chain, and is that something you are going to be addressing because it is something which we discussed with Ms Stratford in terms of --

MR HOLMES: It is indeed something that --

THE PRESIDENT: Yes, then I will leave you to make your submission.

MR HOLMES: -- I will be coming to, sir. To be clear, this is not an attempt to expand the case into Chapter I territory.

THE PRESIDENT: No.

MR HOLMES: The point is that for the assessment of the parties' respective conduct under Chapter II it is necessary to look at it in its context and in the round, and this is important when we come to look at the comparators that they are relying upon, and I will

develop that point in just a moment, if I may.

As well as showing you the contemporaneous documents relevant to the conduct, I would also show you the reactions of the Department of Health and the NHS, the ultimate paying customers for Pfizer's and Flynn's product, and in the process I will address under the factual context the regulatory framework which applied from time to time which we know is a matter of interest to the Tribunal.

Finally, and to the extent that time allows, I will conclude with short submissions on the law and the grounds of appeal, but the ground has been comprehensively covered in writing and so I will aim to be crisp.

So beginning then with my headline points. As was clear from the opening submissions, the appellants take different tacks. Flynn focuses primarily on margin comparisons at limb 1, and Pfizer focuses on pricing comparisons at limb 2, and these different focuses reflect an underlying tension between their respective positions.

Flynn's prices are so high that it is difficult even to attempt to justify them by reference to plausible market-based pricing comparisons, and Pfizer's reliance on tablet ASPs in particular is of no use to them, and

I will develop that submission.

For Pfizer, by contrast, its upstream margins, however you express them, are eye-watering, and it does not try to suggest that they are normal. Their expert in the first appeal accepted that the profits obtained by Pfizer were not normal. It follows that a number of the metrics relied on by each party are unhelpful when applied to the other, and the tension between their respective positions goes deeper than that.

Implicitly, each appellant relies on the other's high pricing to try to avoid responsibility for its own prices, and this is a submission that requires to be unpacked, but in overview, Flynn uses a percentage margin measure as a comparative measure to show that its profitability was not excessive, when that measure was obviously distorted by the high upstream prices charged by Pfizer.

Pfizer, for its part, devises an adjusted ASP to compare with the tablet ASPs which removes Flynn's high pricing from the equation. So in effect each of the appellants contends that it cannot be held responsible for the prices imposed on the NHS; responsibility must therefore either lie with the other's high pricing or the submission must be analogous with Pfizer's ground 4 in the first appeal: responsibility is avoided

completely by reason of the division of their activities, a division which they effected with the object of increasing prices, and we say that that is not the right way to approach matters. The parties' conduct needs to be assessed in the round, without ignoring one or the other party's high pricing.

The Tribunal has seen in broad terms what the parties did and what the combined impact was. In September 2012, they split the manufacture and supply of phenytoin capsules. Thereafter Pfizer was a monopolist in a narrow market for making capsules, and Flynn was an exclusive supplier and therefore also a monopolist in an equally narrow market for supplying capsules. Each was dominant, and each applied very substantial mark-ups.

In consequence, prices for capsules rose very significantly indeed. Overnight the product became around 24 times more expensive than it had been.

Now, in *Hydrocortisone*, you will recall, sir, that the graph showing the parties' evolving prices became affectionately to be known as the Matterhorn and the *Liothyronine* pricing exhibited a similar trend.

In this case, by contrast, you have seen that the graph shows a cliff face, a vertical leap as the price leapt from £2.21 to £59.53 in the case of the 100mg pack

size followed by a mainly horizontal line of high pricing. To see that, if we could turn, please, to {XA1/1/105}. There you see the cliff rise, this is for 25mg capsules, followed by the long plateau through to the end of the infringement period.

Turning over the page, if we could show the next two pages {XA1/1/106} and {XA1/1/107} alongside each other, these are the figures for 50mg and 100mg tablets. Now, for the 100mg capsule there was some suggestion from both Mr Brealey and Ms Stratford that prices were subsequently affected by competition from NRIM, you will recall that, sir, that featured in both of their submissions, which launched a rival generic 100mg capsule in the course of 2014.

It was unclear to me at least quite why they were seeking to revive that contention from the graveyard of the first appeal, but I should briefly lay it to rest. It is true that during the course of the CMA's investigation the parties did modestly reduce their prices in 2014, but if you look at the trend, you see the modest tick down in April 2014, some four months after Pfizer cut its input price, but then see the trend which follows: another flat horizontal line. The Tribunal can form its own views from that figure as to the strength of the competitive constraint of NRIM on

the price of Flynn's and Pfizer's 100mg product.

As regards the reason for the modest tick-down in 2014, the first Tribunal addressed this in the judgment having heard detailed evidence and argument about it. If we could go, please, to XN/1 --

THE PRESIDENT: Pausing there, before we move on, looking at your cliff edge, that is defined by the drug tariff, the blue line.

MR HOLMES: The blue line is the drug tariff and the orange line is the Flynn ASP.

THE PRESIDENT: Yes. The change is because the drug moved from branded to generic.

MR HOLMES: Yes.

THE PRESIDENT: And the theory that you have a different regime of control is that there ought to be competition between generic drugs which will keep the price down. That is the theory.

MR HOLMES: That is correct, sir. So there is a permissive regime in relation to generics in the UK on the basis that competition will act as a discipline on price. That is the hope.

THE PRESIDENT: In each case, do we know with precision how the drug tariff price is calculated? I know I explored this with Mr Brealey when he opened, or do we have a lack of certainty about how it is done?

MR HOLMES: So for this product, which is a category C product, the drug tariff is a function of the list price of the supplier. So category C -- it might help if we went to the relevant categorisation of the different categories.

THE PRESIDENT: Yes.

MR HOLMES: It is 2.162.2 which is on page -- it is {XA1/1/66}. We are in the right document.

You see that category C contains drugs which are not readily available as a generic. So:

"This typically applies when a product is only available as a branded product or from one or two sources. Category C Drug Tariff prices are based on the list price for a particular proprietary product, manufacturer or supplier."

Here of course there is only one or two suppliers, one supplier for three of the four strengths and from April 2014, two suppliers. So the mechanism of competition certainly for three or four -- three of the four strengths was of no application, and for the 100mg -- and for the fourth product, the 100mg product there was one competitor which entered in the course of 2014, but, sir, it was not a member -- I apologise, April 2013, it entered, excuse me, in April 2013, and for that product the supplier was not

in Scheme M and, therefore, it did not supply data which could be used under category M to calculate a drug tariff price.

So category C then was the applicable category, and in that category it was the list price of the supplier which determined the price, and that is recorded, sir, at 2.164 of the Decision over page {XA1/1/67}.

I am going to come, if I may, sir, back to the regulatory framework subsequently, but if I might for now just park the topic.

THE PRESIDENT: Of course.

MR HOLMES: So if we could -- so just to go back to the figure for the 100mg and for the 300mg as well, there is a tick-down as a result of Flynn reducing its prices in April 2014. That was considered in the Tribunal's first judgment, and if we could go to {XN1/2/58} there is a consideration for competitive constraint which NRIM posed.

You see at paragraph 172 reference to Mr Walters' evidence and his acknowledgement that the price reduction was not motivated -- initially motivated by competition from NRIM, and then turning on to page {XN1/2/62} you see in paragraph 183 the Tribunal's finding that the price interaction between NRIM and Flynn was relatively limited:

"NRIM's launch price was well below Flynn's, but Flynn did not respond until nearly a year later; and only once."

And that was the tick-down that we saw.

And the:

"... price reduction was, at best, only in part a response to competition from NRIM."

That was the finding.

The conclusion is then given on page {XN1/2/65} at paragraphs 195 and 196. You see there in 195 the Tribunal rejected the idea of having a different definition of the relevant market for such short different parts of the relevant period, and that is because:

"The main characteristics of the market are broadly similar over the whole period, and the degree of competitive pressure exerted by NRIM, whilst it may have varied, does not in our view appear to have been sufficiently strong to constrain Flynn's behaviour to a sufficient extent at any time. Some degree of substitutability or competition is not sufficient in itself to regard the products as forming part of the same relevant market."

Then looking down the page at paragraph 196, the overall conclusion:

"... we find, looking at all the evidence in the round, that there was clearly some competitive interaction ... but that this interaction was limited in its scope and effect. Continuity of Supply, as a matter of fact, inhibited (even if it did not always preclude) switching and, to an extent, locked in patients to the existing supplier. NRIM did not supply the whole capsule range (although we do not exaggerate the effect of this). It also appears that NRIM's commercial strategy was not to threaten Flynn's position beyond a certain point, and Mr Walters said that this kind of strategy by NRIM was common knowledge in the industry. The mutually reactive behaviour by the two companies was in practice modest. NRIM achieved a significant volume share in the 100mg strength, and then appears to have accepted a degree of pricing parity and stability, not seeking to advance to a position further than it had reached and also possibly finding it difficult to do so had it tried. In our view, on balance, the NRIM Capsule is better regarded as outside the relevant market for the purposes of this case."

Now, I will return to continuity of supply, but just for now to note, the Tribunal reached its conclusion on the significance of continuity of supply fully aware of the fact that doctors tended to prescribe openly.

Continuity of supply guidance nonetheless had an impact at the level of dispensing practice. I am thinking, sir, of your discussion with Mr Johnston on the first day.

THE PRESIDENT: Yes.

MR HOLMES: The overall price to pharmacists and wholesalers and to the NHS that resulted from the vertical leap we saw in the graphs was, on any view, far above the direct and indirect costs incurred by Flynn and Pfizer which are substantially not in dispute. There was indisputably a very large overall return, and that simple fact can be seen from a graph in the CMA's skeleton argument. That is at {XL/3/7}. A very similar version of the graph can be found in the Decision at figure 1.1.

For present purposes, I propose to focus on the 100mg capsule on the basis that that strength accounts for around three-quarters of the volumes that were sold during the relevant period. For your note, that can be seen from the volume data provided at the Tribunal's request. We do not need to go there, but it is at {XJ/35.1} and it is in lines 74 to 79 of the spreadsheet. It is just necessary to bear in mind that the 100mg volumes are three times the volumes of the other three strengths because of the different pack

sizes, so you need to multiply the figures shown there by three, given the 84-pack size rather than 28.

You can see that the costs stack at the base across both appellants represents a small fraction of the price charged. The solid green bar at the base shows Pfizer's costs, both direct and indirect, plus an allowance for a reasonable rate of return, and that is in numerical terms £4.90. The striped green above shows Flynn's costs, both direct and indirect, but excluding the Pfizer input cost, and it also includes an allowance for a reasonable rate of return, in numerical terms it equates to £2.28. So the combined measure of costs and a reasonable rate of return on the CMA's case is £7.18, and above the costs shown in red, just focusing on the 100mg, as I say, are the further amounts charged respectively by Pfizer and by Flynn leading together to the overall average selling price of £54.40, and that is a combined excess of £47.22 which generated nearly £100 million for the parties over the course of the four-year period of the infringement, around 37 million to Flynn and the balance to Pfizer. Of that costs stack, Pfizer's excess amounts to £32.67, and Flynn's excess amounts to £14.55 on a per-pack basis.

For the 100mg strength, each of the appellants independently therefore adds an amount well in excess of

their combined costs of production and supply, including the cost of capital.

Now, we will come to the law, and we will come to the facts, but as an initial observation, it is in my submission striking that each of the appellants adopts a narrow focus in order to avoid considering their conduct in the light of this overall picture, so on Flynn's side this narrowing of focus is apparent from its case on margin comparators, and I would like to address you on that first.

THE PRESIDENT: Just so that we are clear, the hatched green Flynn costs, does that include the price that is paid by Flynn to Pfizer?

MR HOLMES: No, sir, the adjustment that is made to this chart in order to show separately, to break out the excess for each of the separate appellants, removes the Pfizer excess from the costs stack of Flynn, and that is exactly the point that I am coming on to now in order to understand how distortive the effect of including that in Flynn's costs stack is when you come to consider Flynn's return on a percentage basis, on a relative basis, on its return of sales.

THE PRESIDENT: I can see it would make a huge difference, but are you not treating, in excluding it, what are, on the Decision's grounds, independent infringements as in

some way connected?

MR HOLMES: Well, sir, the Decision analyses the conduct of the two parties in a way which takes account of the contribution of each, and in my submission that is the correct way to approach matters. So the arguments that I am about to develop are not novel arguments which depart from the approach that was taken in the Decision; on the contrary, they assess the comparators in a way which is alive to the contribution of each party's conduct to the overall pricing that was achieved in this market with effect from September 2012.

THE PRESIDENT: A separate question. Looking at this graph, the set of four rates, is the drug tariff rate the same for all of the different dosages? I mean, obviously adjusting for any material differences.

MR HOLMES: No, sir, there is a separate drug tariff rate for each of the products.

THE PRESIDENT: So are they pricing up to the drug tariff in each case?

MR HOLMES: The drug tariff is the product of the list prices and not vice versa.

THE PRESIDENT: Right, okay, so it is not a control at all?

MR HOLMES: It is not a price control, and indeed, it is perhaps a mistake to think too readily of the drug tariff as a price control at all. The drug tariff is

the way in which the rate of reimbursement is decided upon, and the way in which it is calculated is designed to reap the benefits of competition where it occurs, but the regime is otherwise permissive so that insofar as there is no competition, the drug tariff tracks the list prices. It reflects the fact that generic prices are not regulated in the UK system by any sector-specific regulatory intervention.

PROFESSOR WATERSON: Just to check on the mechanism on this: so the companies, or Flynn, I suppose in this case, would contact the people charged with setting the drug tariff and say: look, you have got to change the drug tariff because the price has changed?

MR HOLMES: Yes, so my understanding is that is correct and you will recall that indeed there were a number of documents in, I think it was *Liothyronine*, which showed periodic notifications of changes in the list price.

PROFESSOR WATERSON: Yes, I just could not remember whether they were also category C. These categories tend to go in and out of the mind.

MR HOLMES: No, indeed. You will recall that in *Liothyronine* the product was in category C for a portion of the infringement period, although it bounced around a little between different categories.

PROFESSOR WATERSON: Thank you very much.

MR HOLMES: You are welcome.
THE PRESIDENT: We, I think, are going to need some assistance, not now but probably in closing, about what actually the drug tariff is intended to do. I quite understand that part of its function is to operate as a reimbursement rate, but the objective is not just to reimburse pharmacies appropriately, but to enable the drug tariff to follow competitive prices down.
MR HOLMES: Yes, indeed.
THE PRESIDENT: Which clearly did not occur.
MR HOLMES: There was no competition, though, sir, in this market that would bring prices down, and this is one of the difficulties.
THE PRESIDENT: Well, yes, the question is whose difficulty is it, because what I think we are going to be getting from the appellants as an argument is that leaving on one side the £30 drug tariff for the tablets, let us park that for the moment, that if the system is causing the drug tariff price to be extracted from, let us say, a single price because there is no competition, then why can you not just take advantage of the system as it is because you have a form of control that is allowing you to do that?
MR HOLMES: Well, sir, the competition law, in my submission, exists as a general background constraint on

economic activity in the UK.

THE PRESIDENT: Right.

MR HOLMES: The absence of a regulatory regime which caps the price of generic pharmaceutical products is on no basis an excuse for an exploitative abuse if the CMA succeeds in making out its case that these prices were excessive and unfair.

THE PRESIDENT: So your position, I quite understand it, is that we do not really need to worry about the drug tariff regime, at least so far as it applies to generics, because it is actually the domain of competition law pure and simple with no need to consider the regulatory regime at all. It is actually an irrelevance.

MR HOLMES: I do not think I need to go so far as to say the regulatory regime is irrelevant. It is relevant context, it is important that the Tribunal understands it and its idiosyncrasies, but I do say that in relation to products where there is no competition and there is accepted dominance, no dispute about that, and the parties introduce a strategy of radically increasing the profitability of a product, one can and should consider the compatibility of that conduct with competition law, and that is not displaced by any feature of the drug tariff regime.

THE PRESIDENT: And the drug tariff regime in a competitive market, it follows in arrears?

MR HOLMES: That is right. So it harnesses competition and ensures that the drug tariff adjusts to reflect that competition once it is in the market.

THE PRESIDENT: What is the extent of the arrears? Is it monthly, quarterly?

MR HOLMES: It is quarterly, as I understand it, sir, yes. You will recall I showed you the relevant passage, I think, during the course of Monday's proceedings.

THE PRESIDENT: Yes, thank you.

MR HOLMES: For completeness, the one oddity in this is the tablet drug tariff which does not follow the ordinary approach to the determination of the drug tariff.

Effectively what happened was there was a negotiation between Teva and the Department of Health after a particularly egregious case of increased pricing by a monopoly supplier, and the result was that the parties agreed a lower price, and we will consider the consequences of that for the analysis on this other separate market, capsules, it is a point that I will come to shortly, but it does not fit neatly within the drug tariff, the submission that I have just been making. If you look at the drug tariff as it ordinarily applies, there are products where there is competition,

and the mechanism which applies under category M where there are multiple generic sources is to reflect the effect of competition by determining the drug tariff by reference to average selling prices in the market, but there are other markets where you do not yet have competition, you have one or at most two sources of supply available, category C is an example, category A is another, and in relation to those, the drug tariff is permissive because it is set by reference to list prices.

MR DORAN: There is no other mechanism apart from general competition law, in your submission?

MR HOLMES: Well, sir, that has been a matter of contention in a number of these cases.

Our submission is that there was no other workable mechanism during this period because -- well, it is perhaps a point I will return to. It is a slightly involved point with a long history.

MR DORAN: Have I just taken you off your construction?

MR HOLMES: No, no, no, it is an important point, sir and it is one I will come back to.

THE PRESIDENT: But you are accepting that although one has these various categories, it is within the lawful power of the Department of Health to say: well, we see what price category M results in, we do not like it, we are

1 going to intervene. That is something that is perfectly
2 possible, as illustrated by the Teva tablet case.
3 MR HOLMES: Remember, sir, that was with the agreement of
4 Teva, so Teva agreed to change the price. If Teva had
5 toughed it out -- and we will see how the appellants
6 responded during meetings with the Department of Health,
7 but if Teva had toughed it out, I do not think this
8 mechanism would have been available because Teva could
9 have held the Department of Health to the usual
10 mechanism for determining category M pricing.
11 THE PRESIDENT: I see. So what you are saying is that the
12 Teva tablet example is an agreed departure from the
13 price that would otherwise pertain as a limit because
14 Teva accepted that they should price differently?
15 MR HOLMES: Yes, indeed, sir, and indeed, just to be clear,
16 the drug tariff does not, as such, impose a limit.
17 Where there is no competition to bring prices down,
18 participants in the market are free to increase their
19 ASPs under category M as Teva did in the period prior to
20 the adjustment, and equally, they are free to increase
21 their list prices under categories C and A as occurred
22 in the present case, but in none of those examples can
23 one characterise the drug tariff as a price control, and
24 there is nothing in that permissive scheme of regulation
25 which prevents ex post competition law from applying the

usual limits which attend dominance, the special responsibility not to engage in exploitative abuse.

THE PRESIDENT: Just to complete the circle, when one is talking about branded drugs, there one does have a price cap; is that right?

MR HOLMES: Sir, branded products are within the PPRS mechanism, and under the PPRS mechanism there is a profit cap and various other rigidities which I will develop subsequently, professor Waterson may recall this from the first trial, but in general it sets a sort of envelope of profit with various allowances that a company can make on its portfolio of branded medicines, so it is an avowedly portfolio-based method to limit overall profitability.

THE PRESIDENT: Can a pharmaceutical company at one and the same time have products in its portfolio that are branded and not branded?

MR HOLMES: Indeed, and most do.

THE PRESIDENT: Okay.

MR HOLMES: So, for example, Flynn had both branded and generic products in its portfolio, Pfizer does as well. There is then the separate Scheme M which provides the data for category M, but that is also a voluntary arrangement, and in this case, Flynn was not a member of Scheme M but Teva was.

THE PRESIDENT: I think we know this from *Hydrocortisone*, but I will just double-check that I have it right: if you are not within the voluntary scheme, then you are subject to the Secretary of State's powers to review your prices?

MR HOLMES: Yes, subject to you being in neither the PPRS or Scheme M. So you recall that was the oddity which was resolved, I think, by the 2019 amendment.

THE PRESIDENT: Is PPRS voluntary then?

MR HOLMES: The PPRS is voluntary. I appreciate it is a complex landscape and we will probably need to return to it, but --

THE PRESIDENT: Well, it is, and I think we have indicated in correspondence that we are going to need to understand quite a lot about this --

MR HOLMES: Yes.

THE PRESIDENT: -- even if ultimately our conclusion is it does not very much matter.

MR HOLMES: Yes, sir, and to be clear, my submission is that the interaction between price and regulation is plainly something that the Tribunal will want and probably need to grapple with, but my submission is that there is not a short and easy answer to this case on the basis that somehow category C represented a carte blanche, if you like, to Flynn to set its prices wherever it likes under

general competition law.

THE PRESIDENT: I certainly agree there is not going to be a short and easy answer to this case, I absolutely accept that.

MR HOLMES: I was coming to address you on Flynn's margin comparator, and in terms of the graph in the CMA's skeleton argument, you have rightly apprehended, sir, that what Flynn does is to use the solid red bar representing Pfizer's very large excess profits as part of its overall cost stack for the purposes of determining a percentage margin figure, and you can see that that will have the obvious effect of very greatly depressing the margin that results.

In its skeleton argument, it goes so far as to describe the resulting percentage of 37% across that stack as relatively modest, and it contrasts that return on sales percentage with the return on sales earned on other different products and by other different firms. We say that there are two reasons to be extremely cautious of this: first, the relative margin comparison which sits at the heart of Flynn's case conveniently ignores the stark reality.

As we shall see -- and I will take you through the documents on this -- Pfizer's input price was not some neutral contextual feature of Flynn's situation. On the

contrary, it reflects the parties' joint strategy, carefully planned in advance, and captured in the quotation from the first judgment, to split manufacturing and supply, de-brand the product, substantially raise prices and each take a substantial share of the resulting profits.

The second point goes to the assessment of a reasonable rate of return for Flynn. The effect of Pfizer's excess profits is heavily distortive of Flynn's input costs, rendering them highly abnormal. The result is to depress Flynn's return on sales margin, which is simply the percentage by which revenue exceeds costs, and the abnormality of that situation renders any simple comparison of that percentage margin with the percentage margins earnt in other contexts unsuitable as a means of assessing Flynn's economic profitability on capsules.

Breaking that down, the starting point is that a simple return on sales measure is not in itself a good basis for understanding the economic profitability of any activity. To understand economic profitability, one needs to assess the cost of capital and the return that is required to cover it, either directly or indirectly.

Two businesses may have very similar returns on sales but vastly differ in their economic profitability depending on how much capital they have invested, which

is not captured in the return on sales figure, what their input costs are, which is not covered straightforwardly in the margin figure, and how much risk they are running.

So just to give a couple of homely examples, if I may. It is always slightly risky when a lawyer comes up with examples to a panel which includes an economist, but if you will bear with me. So take a street vendor with no capital costs, and a high street store with substantial capital tied up. Let us say they both sell coffee and let us say they achieve the same return on sales: they sell a cup of coffee for £3 and their input costs are £2. So that is the same return on sales, same margin of price over costs. But they obviously have hugely different capital invested which should have the benefit of a return, and the underlying profitability, taking account of the cost of capital, would differ significantly between the businesses once that is factored in.

ROS margins on their own do not tell you anything about the capital employed in the business, so that is the first point. They also tell you nothing about the risk entailed by the activity. So imagine another example of two businesses, so one is a middle man with stable long-term contracts in place, purchasing some

expensive capital goods at an agreed high price and selling them to customers with inelastic demand at a relatively low percentage margin, and that would show a low return on sales. You have got high input costs, you have got a low percentage margin, you have got inelastic demand and long-term contracts in place.

Compare that with a middle man buying perishable goods at a low price and selling them on with a substantial mark-up to customers with elastic demand. This would show a high return on sales, but the underlying economic profitability differs again vastly. If one approached return on sales as a measure of profitability, you might conclude that the first business was less profitable than the second, because it had a low percentage margin, whereas the latter has a high mark-up on its perishable goods, but in truth, that would take no account of the costs structure or the levels of risk involved, and in fact if one looked at these other considerations, the first business is on a one-way bet: it has long-term contracts in place, it has high input costs, low percentage margins, but very stable demand. The latter has high margins on the products it sells, but the products are perishable and demand is elastic. The second business is on a knife-edge because the demand could fall out of the

picture at a moment's notice, and the high margins that it earns, its high return on sales just does not capture that.

If you were deciding where to invest, you would expect a much higher return in the latter high-risk scenario than in the former scenario. This is the point that you put, sir, to Ms Stratford during the course of submission.

PROFESSOR WATERSON: You have challenged me as an economist on this. I am wondering how the business with a very elastic demand is able to earn a price substantially above cost.

MR HOLMES: That is a very good question. We do not know anything about the competitive conditions of the situation it finds itself in.

PROFESSOR WATERSON: But if it was very elastic, then its margin would necessarily be small.

THE PRESIDENT: By definition, if you have an elastic demand, then you have a competition.

MR HOLMES: Yes.

PROFESSOR WATERSON: No, I am just questioning some of the details of the example, it is not a major point in the case.

MR HOLMES: Yes, but I hope that the Tribunal would accept the basic proposition that return on sales is

uninformative taken on its own as a measure of economic profitability because it does not account for all of these other factors.

THE PRESIDENT: Well, I think I understand the point about risk, but can I go back to your anterior point, the capital that is included in a business, and I want to understand just how far you agree or disagree with the process for determining the gap between cost and price.

Now, let us define price as the price of the unit in question, so we are leaving out of account all kinds of portfolio or overall profitability, we are just looking at the price that your cup of coffee sells at.

The interesting thing, I think, is cost. If we are computing the cost of the coffee, we are looking at the costs that are directly attributable to the making of that coffee, in other words, the beans that go into that cup and the fraction of an employee's time that it takes to making that cup. So is not one, by identifying the costs that are relatable to this unit, the cup of coffee, does that not strip out the capital costs that you have incurred generally for the production of many cups of coffee? I mean, are you not isolating those?

MR HOLMES: Only if you have assessed the capital employed and you have determined an appropriate allowance for the cost of capital, having regard to the risk to the

business.

THE PRESIDENT: Right, so you are saying cost of capital is quite literally a cost?

MR HOLMES: Cost of capital is certainly -- it is a cost of doing business, undoubtedly.

THE PRESIDENT: So it is not a return; it is a cost?

MR HOLMES: No, indeed, and cost of capital is the metric by which you can then compare different business propositions and profitability of different activities.

THE PRESIDENT: So do we see in the figures that have been provided by the CMA, which as I understand it are agreed, a line in those calculations that is the cost of capital for Flynn and for Pfizer?

MR HOLMES: Yes.

THE PRESIDENT: So there is a line there?

MR HOLMES: What the CMA did was it evaluated the capital employed by Flynn and then it applied a weighted average cost of capital assessment to that figure to determine a return on capital employed, which was then added as a reasonable rate of return.

THE PRESIDENT: Well, no, I am not interested in the rate of return, I am interested in how you have computed the direct and indirect costs for the capsules that are employed. Now, it may be we will have to look at the spreadsheets to see where that cost line features, but

my understanding -- and it could be completely wrong -- is that there is not such a line.

MR HOLMES: It is a different category of costs.

THE PRESIDENT: Right.

MR HOLMES: There is direct costs, there is indirect costs, and then reasonable rate of return means the same thing as the cost of capital.

THE PRESIDENT: That, I think, is something we are going to have to debate because I am not sure I accept that without more.

MR HOLMES: Yes.

THE PRESIDENT: That is why I have been asking about costs because I have been defining the gap between price and cost as also being eroded by a reasonable rate of return. In other words, I have not been classing it in my conversations with Ms Stratford as a cost.

Now, it may be that it should be, but, if it is, it is not in my spreadsheets which I am working on, the gap between cost and profit.

MR HOLMES: No, I understand. I think taking it in stages --

THE PRESIDENT: Yes.

MR HOLMES: -- the CMA's position, following previous cases, is that the correct approach is to assess, if you like, the reasonable profitability that would be dictated by

the cost of capital that you would expect for the business, and that is an approach which is taken --

THE PRESIDENT: Just pausing there, though, you are therefore looking at a cost which is not disaggregated by reference to unit.

MR HOLMES: Well, you can disaggregate it by unit.

THE PRESIDENT: Have you done that?

MR HOLMES: Yes, there is a figure that divides the assessment of cost of capital by the number of units sold to supplier per unit basis.

THE PRESIDENT: Because, you see, I think the problem that we may have to consider in greater detail is how -- well, in certain circumstances, cost is a flipside of price, and price is a flipside of cost, and I am not sure that I have been classifying myself your return on capital as a cost, but as a layer above the cost that you have computed for the production of your cup of coffee or your capsule.

MR HOLMES: I understand, sir.

THE PRESIDENT: That is how I have seen the spreadsheets that have been agreed.

MR HOLMES: Yes. It may be, sir, that this is simply a question of nomenclature --

THE PRESIDENT: It may be.

MR HOLMES: -- and that there is no substantive debate

between us. So there is undoubtedly a distinction between the direct and the indirect costs.

THE PRESIDENT: You see, the reason I think this is really mattering is because Ms Stratford has been addressing you on the basis that you have got cost and then you have got the return to the undertaking, the profit, and she is saying: let us look at what is an appropriate return on sales, so she is leaving ROCE out of account altogether. You are saying it comes in, but not the way she is saying it comes in as an overlay on costs, you are saying it is a cost, so there is, as I see it, a very big difference between the way Flynn is carving it up and the way the CMA is carving it up.

Now, I have no idea who is right or who is wrong, but there is, I think --

I mean, I have that right, Ms Stratford, have I? Do not feel obliged to rise now, but if I am just barking up the wrong tree then let me know and I will shut up.

MS STRATFORD: I was certainly addressing you extensively on the fact that the CMA's approach is exactly I think as you have just been putting it to Mr Holmes, to equate cost of capital with return on capital, and that is certainly an important part of our submission. It is then a separate part of our case, if you turn to the ROS and look at margin comparisons and so on.

MR HOLMES: Yes. Maybe this will help, sir. I mean, just standing back, it is clear that what we need to try to do is to arrive at a way of understanding economic profitability under competitive conditions and comparing that with the returns that are achieved in this market to see if the prices reflect those normal and sufficiently competitive returns, the benefits that would be reaped under conditions of normal and sufficiently effective competition or whether they are significantly above that level.

Now return on sales can be a way of getting at economic profitability. It can be a way of understanding cost of capital, the return that an investor would require in a particular business, but to be informative, great care must be taken to identify comparators which are similarly situated across a number of different dimensions.

So you are just looking at this simple return on sales figure for various different businesses. My submission has been that that figure can mask profound differences of economic profitability because of differences in terms of the capital intensity of the business, which the ROS will not show, in terms of the costs structure, which the ROS will not show, and in terms of the level of the risk involved in the business,

which the ROS will not show.

So you need to find, then, a comparator that is similar across several different dimensions if you are using return on sales as a way of getting at underlying profitability, because of these various factors that affect profitability.

Now, that is not a counsel of perfection, it is simply the fact that you are basically looking at businesses where a number of different dimensions are relevant to profitability, and you are just looking on their return on sales and you are trying to reverse-engineer from that an understanding of economic profitability, so there does need to be, we say, quite a good or careful alignment between your comparators across several different dimensions.

THE PRESIDENT: Yes.

MR HOLMES: The unusual nature of the capsules business, with its high input costs, high absolute returns and low risk, make it difficult, we say, to apply a simple ROS comparator approach. We have seen the high input costs that result from the share of profits taken by Pfizer, we have also seen the high absolute returns, and the Tribunal will hear evidence as to the risks undertaken by Flynn, but here it is relevant just to see what the Tribunal considered about those risks in the first

appeal.

If we could go, please, to {XN1/2} --

THE PRESIDENT: Mr Holmes, I am sorry, I am interrupting you on something completely different.

MR HOLMES: Not all, no, no, please.

THE PRESIDENT: We can only run until just before 4.00 for my own reasons. I see that the shorthand writer has been very patiently bearing with us. We only have a little time to go, but would a break assist?

We are incredibly grateful for your efforts and if you are not under any time pressure, Mr Holmes, even though there is not much on the other side of the five-minute break, we will perhaps take one.

MR HOLMES: Yes, I am grateful, sir.

THE PRESIDENT: I am very grateful to you. We will rise for five minutes.

(3.35 pm)

(A short break)

(3.47 pm)

MR HOLMES: Sir, I appreciate there is not long that you have left, but there is one point, if I may --

THE PRESIDENT: I have then got, I am afraid, a question, but you go first.

MR HOLMES: Completely understood. I am in your hands. It was simply just to clarify the cost and return point

which we got tangled in.

THE PRESIDENT: Oh, well my question is exactly on that.

MR HOLMES: Shall I quickly make my submission and then see if it answers your --

THE PRESIDENT: You make your submissions and then I will give you something to think about, I hope.

MR HOLMES: The answer, I am told, is that cost of capital is both a cost and a return, depending on whose perspective you look at it from.

THE PRESIDENT: Yes.

MR HOLMES: For the business, it is a cost which they have to pay to investors to get them to invest their capital, so for them it is a cost. But equally for the investors it is a return, it is what they get on their capital.

There is, it transpires -- you are quite right, sir, that your spreadsheets lack a line which reflects the CMA's assessment of that element of cost or return, the plus in cost plus, and that is because, I am afraid, perhaps reading a little bit too literally the request in the letter, they provided the direct and the fixed costs, but they did not provide that element of their calculation. That can be very rapidly rectified.

THE PRESIDENT: Do not let us do any rapid rectification because we asked for fixed and variable costs or direct and indirect costs quite specifically, and I don't think

anyone is to be blamed on the CMA side for responding literally because that was what we wanted.

We are, I think, going to have a significant debate about where this fits, and it is very helpful that we have articulated it into something now. So let us move on from the Matterhorn to Mr Holmes' coffee shops.

Let us suppose two coffee shops, identical in all respects in that they are serving exactly the same coffee, they have exactly the same space, they have exactly the same number of baristas and the same machines so their costs are like for like.

It is simply that coffee shop A is a family-run business that has been going for years, whereas coffee shop B has been purchased, and we will postulate a very expensive coffee shop, it has been purchased for £100,000, which has been borrowed from the bank, and the rate of interest is 10%.

Now, you are saying that the £10,000 rate needs to be factored into the costs of a cup of coffee sold by shop B, but not by shop A.

MR HOLMES: If you are assessing profitability to see whether --

THE PRESIDENT: Well, I am trying to determine cost.

MR HOLMES: Yes.

THE PRESIDENT: So what we will find, however you choose to

allocate the £10,000, whether it is by revenue or by number of coffee cups produced, but somehow you are going to have to find a home for a portion of that £10,000 to refer it to the cup of coffee.

MR HOLMES: Yes.

THE PRESIDENT: So even though the product is exactly the same in these two examples, the cost base of the two companies will be different to the tune of this interest on the £100,000 that has been borrowed to purchase the coffee shop.

MR HOLMES: Well, no, sir.

THE PRESIDENT: No. Okay, why not?

MR HOLMES: That is because there is capital invested in a family-owned and run business --

THE PRESIDENT: Ah, right.

MR HOLMES: -- which would also need to be reflected -- and indeed, the whole value of cost of capital is that it enables an assessment of the value of the business and its profitability. It is for comparative assessments that cost of capital is established. It is a means of comparing the profitability of different businesses.

THE PRESIDENT: So assuming that the bank has its pricing right in terms of 10% interest, you would have in this case an equivalent cost of capital; is that right?

MR HOLMES: Yes, if you are assessing the profitability of

the business --

THE PRESIDENT: Okay. And what happens --

MR HOLMES: -- and you expect each to have the same (inaudible) a coffee shop business.

THE PRESIDENT: -- what if the bank is rapacious and has gouged coffee shop B, and is in fact charging not 10% but 20% interest, how do you adjust the return on capital there? Do you adjust it down or do you say that is the cost there is? How do you do that?

MR HOLMES: So you are imagining a world in which, for whatever reason, the cost of capital that is agreed is not one that --

THE PRESIDENT: Well, all I am doing is I am spinning back your opportunity cost in coffee shop A into an excessive cost in coffee shop B.

MR HOLMES: I think you need to try to find a reliable measure for cost of capital by looking at perhaps more than one example, in order to understand whether the rate of interest which is being achieved by coffee shop B -- that is the borrowing one, is it? I can't remember whichever is the one --

THE PRESIDENT: Coffee shop B is the one that is borrowing, yes.

MR HOLMES: -- is an apt comparator if you were assessing the profitability of coffee shop A.

THE PRESIDENT: You see, we are moving very, very rapidly away from costs that a lay person would understand into a rather manipulable form of costs which is likely to do something of a disservice when one is looking to see an excessive price over cost, because cost of capital is a very manipulable thing, because you have just said that the coffee shop A, not loaded down by debt, nevertheless has a cost which in fact it does not incur and need not be reflected in its pricing, and yet nevertheless is, you say, something that would serve to inflate its costs base.

So you might get a situation where the price of coffee shop A is lower by the prorated amount of £10,000 because it is not a cost that it is actually spending, and yet its costs base has moved up by that amount, and that, it seems to me, is introducing a subjectivity into what ought not to be subjective in a way that I think we need to be unpacking quite carefully.

MR HOLMES: But investors in sectors, as a matter of course, assess, use weighted average cost of capital, use cost of capital metrics to assess the value of investments. It is designed precisely to achieve some objective insight into the profitability of a venture or of a business.

THE PRESIDENT: Of course, no one is disputing that, but

what I am pushing back on is what we include in cost in order to discern whether the gap between cost and price is excessive according to limb 1 of *United Brands*, and I think we were agreed that certain costs fall out of account.

So, for instance, if you are as a coffee shop engaged in spectacularly expensive research and development for future forms of coffee and you are incurring costs of several million in order to deliver that perfect cup of coffee and turn yourself into the next conglomerate coffee-deliverer, that is a cost that would not feature in the unit cost of the cup of coffee, and your ROCE figure is something which sits somewhat uncomfortably between actual cost and a kind of unreal cost because the coffee shop A example is what I would call an unreal cost. I quite see that if you are measuring the value of a business and the return that one will get on an investment you need to look at the capital there is, but if you are looking at how the coffee shop A is charging, then I am not sure it ineluctably follows that the cost base is the same as what an investor would regard as a return on capital because we are using these computations for different purposes, and here what we are looking at is the cost of your cup of coffee, what is a proper rate of return on

the cup of coffee and then we are saying: is the gap between those two figures and the price charged excessive.

So that is what we are doing, and the metrics that we are using to do it need to be fit for purpose, and what I am pushing back on is, is your ROCE figure a fit for purpose measure, and the signal I am getting as regards your coffee shop A example, whilst absolutely right, we asked ourselves the question in the break and Professor Waterson told me exactly what you told me, that there is a cost of capital, but I am really questioning whether it is a relevant cost for the purposes that we are exploring here, but that is my concern now, and I am putting it on the table because you are here to help me with my concerns so we can get it right.

MR HOLMES: That is completely understood and I am going, I think if I may, to take advantage of the school bell and return to you with my homework tomorrow, but I understand the question, sir.

THE PRESIDENT: No, I am very grateful.

MR HOLMES: I will seek to address it tomorrow.

THE PRESIDENT: It is very tricky, but it is not as simple as just putting an extra line in your cost schedule. I think the debate we are having is should that line be

there.

MR HOLMES: No, I fully understand that. I was conscious that you had a specific concern about the spreadsheets which had been provided and what they contained.

THE PRESIDENT: Indeed. It is very good to know that it is in or out and it is out.

MR HOLMES: Yes. Whether it is in the spreadsheet or it is out of it, it does not resolve the substantive matter which the Tribunal has to determine --

THE PRESIDENT: Indeed.

MR HOLMES: -- which is about how you assess a reasonable rate of return for determining whether the profitability here was excessive.

THE PRESIDENT: And whether it is properly to be included in what the spreadsheet does do as a cost or whether it is a separate item as a rate of return because you are, I think, framing the question differently because Ms Stratford is saying you treat ROCE and ROS as alternatives and she prefers ROS, not ROCE. You are saying, no, that is actually not an option, ROCE is a cost and needs to be embedded in the costs figures that we use so that we end up with just a single figure of cost including return, which is a gap.

MR HOLMES: But, I am sorry, I do not think that the debate between us turns on how one describes that component,

whether one describes it as a cost or a return, whether one looks at it from the perspective of the investor or from the perspective of the business, and equally, just by way of clarification, we do not say that ROS cannot shed light on economic profitability, on cost of capital. It is possible to use it as a proxy, as a means of understanding cost of capital, but for that you do need to ensure that the businesses you are comparing are comparable along several dimensions, and that was the submission that I was making before we rose.

THE PRESIDENT: No, that is very helpful. I do not think -- and Ms Stratford will want to think about this -- I do not think Ms Stratford is using ROS in that way. I think she is seeing, but it may be just me, in which case you can all correct me -- I think that Flynn's categorisation sees ROS as something conceptually different to cost, but we will leave it there and I can be corrected, but I am very glad we have got the debate out there. We have found our replacement for the Matterhorn and the marble rolling down it: it is coffee shops.

Thank you very much. Would it help if we started early tomorrow or is 10.30 fine?

MR HOLMES: I think we are in good shape to start at 10.30

if the Tribunal is content to go over the short adjournment.

THE PRESIDENT: Oh, indeed, provided we finish around 4.15, that is fine.

MR HOLMES: I am extremely grateful.

THE PRESIDENT: Thank you very much. 10.30 tomorrow morning.

(4.00 pm)

(The hearing adjourned until 10.30 am on Thursday, 9 November 2023)