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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1099/1/2/08

Victoria House,
Bloomsbury Place,
London WC1A 2EB

15th January 2009

Before:

VIVIEN ROSE
(Chairman)
PROFESSOR PAUL STONEMAN
DAVID SUMMERS

Sitting as a Tribunal in England and Wales

BETWEEN:

NATIONAL GRID PLC

Appellant

- v -

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

supported by

SIEMENS PLC
CAPITAL METERS LIMITED
METER FIT (NORTH WEST) LIMITED
METER FIT (NORTH EAST) LIMITED

Interveners

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HEARING (DAY 1)

APPEARANCES

Mr Jon Turner QC, Mr Josh Holmes, Mr Meredith Pickford and Miss Laura Elizabeth John (instructed by Pinsent Masons LLP) appeared for the Appellant.

Miss Monica Carss-Frisk QC, Mr Brian Kennelly and Mr Tristan Jones (instructed by Ofgem) appeared for the Respondent.

Mr Christopher Vajda QC and Miss Kassie Smith (instructed by Hill Hofstetter LLP) appeared on behalf of Siemens Plc.

Mr Christopher Vajda QC and Mr Ben Rayment (instructed by Slaughter and May) appeared on behalf of Capital Meters Limited.

Mr Fergus Randolph and Miss Sarah Abram (instructed by United Utilities Group plc) appeared on behalf of Meter Fit.

1 THE CHAIRMAN: Mr. Turner?

2 MR. TURNER: May it please the Tribunal, I appear today for the Appellant, National Grid, with
3 Mr. Holmes, Mr. Pickford and Miss John. My learned friends Miss Carrs-Frisk, Mr.
4 Kennelly and Mr. Jones appear for Ofgem. Mr. Randolph and Miss Abram for Meter Fit.
5 Mr. Vajda and Miss Smith for Siemens. Mr. Vajda, again, and Mr. Rayment for Capital
6 Meters. I believe that completes the total. So, you have a galaxy of talent arrayed before
7 you - and myself.

8 First off, Madam Chairman, Happy New Year. We have only two matters of housekeeping
9 to address before diving straight into today's business. The first is that the Tribunal may not
10 have noticed that an agreed statement of facts should have been slotted into the Tribunal's
11 files. If you pick up Bundle CB2 , Core Bundle 2 (CB1 and CB2 containing the essential
12 documents for the case in the main), and you go to Tabs 19 and 20 you will find there two
13 versions of the agreed statement of facts. That is not particularly sinister. At Tab 19 is
14 Ofgem's version. What that does is to strictly isolate the sentences and parts of sentences
15 which Ofgem is prepared to agree. If you then go behind that to Tab 20 and have a look at
16 that, what you will see there is National Grid's version. Here we have reproduced a colour-
17 coded copy of s.2 of the Notice of Appeal, which is what, Madam Chairman, you asked the
18 parties to seek to agree and disagree. We have indicated in green the parts that are agreed,
19 and you will see in black the parts that Ofgem is not prepared to agree.

20 THE CHAIRMAN: So, with the one at Tab 19 it is using agreed in a fairly loose sense then. I
21 mean, by whom is this agreed to be a statement of facts then?

22 MR. TURNER: The particular propositions in the text are the propositions that Ofgem says it is
23 prepared to agree

24 THE CHAIRMAN: Those are agreed with you, are they?

25 MR. TURNER: Those are agreed with National Grid.

26 THE CHAIRMAN: With the interveners as well?

27 MR. TURNER: No. This has been a dialogue between Ofgem and National Grid. I do not
28 believe that the interveners have also contributed to this dialogue.

29 THE CHAIRMAN: I see. The one at Tab 20 then, that incorporates all the agreed facts at Tab
30 19?

31 MR. TURNER: You will see that it mirrors it precisely. What it does do, however, is also put the
32 surrounding text in upon which we continue to rely in some cases, which we say is
33 necessary in order to appreciate the context of the facts which are agreed.

1 THE CHAIRMAN: So, the green bits are the bits which you contend for, but which Ofgem does
2 not currently agree?

3 MR. TURNER: The green bits are the bits that we both are happy with. The black bits are the
4 parts that Ofgem have said it is not going to agree.

5 THE CHAIRMAN: So, are the green bits then the bits that come in Tab 19?

6 MR. TURNER: Yes, they are. They are the Tab 19 parts. Now, behind both of those versions
7 are two identical, very short documents within the same tabs. So, if you turn, at the end of
8 Tab 20 to what is marked as p.1083-64 you have a slim page and a half which is entitled
9 'Agreed Economics of Metering'. If we get away with the economics of metering being
10 reduced to a page and a half I think everybody will be very happy. Those are the essential
11 propositions on which both parties are prepared to agree.

12 THE CHAIRMAN: Even though they are in black rather than green.

13 MR. TURNER: Even though here they are in black, yes. Similarly, another agreed document -
14 the page behind that, and the final page in both tabs -- That is called market development
15 since the Authority's Decision. That, again, is a page and a half. It is a statement about
16 things that have happened in the industry since the Decision, which both parties are
17 prepared to agree about. That is the first housekeeping issue.

18 The second issue is purely formal - to remind the Tribunal of the timetable that the parties
19 have agreed upon, which is that I will make opening submissions until, we expect, lunch-
20 time tomorrow. Ofgem, and its supporting interveners, will then kick off and make opening
21 submissions until close on Monday. On Tuesday and Wednesday the factual witnesses will
22 take the stand, beginning with the Appellant's witnesses of whom there are four - Mr.
23 Shoemith, Mr. Avery, Mr. Way, and Mr. James. After that the sole Ofgem factual witness,
24 Miss Frerk of Ofgem. Following that the experts will take the stand, beginning with
25 National Grid's experts. There are three of those - Mr. Williams, Mr. Shuttleworth and Mr.
26 Matthew of NERA. After that, there will be the two experts for Ofgem - Professor Grout
27 and Mr. Keyworth.

28 That will take us to the end of Monday of the following week. Then there are two days set
29 aside for the closing submissions.

30 Madam, with those introductory comments I turn to the submissions and begin with a
31 number of opening remarks.

32 This is National Grid's appeal against Ofgem's Decision of 21st February, 2008. I would
33 ask the Tribunal to begin by taking up Bundle CB1, which contains the Decision at Tab 1.
34 This is, of course, the document which the Tribunal is being asked to overturn by National

1 Grid and to uphold by Ofgem. I would ask you to go first to the operative part of the
2 Decision on p.130, all the rest of it being essentially the reasons. I will take these
3 paragraphs in turn to see precisely what it is that we are appealing against. Paragraph 1 is
4 the declaratory part. You will see that Ofgem has found that National Grid has abused its
5 dominant position in the market for the provision of domestic-sized gas meters in Great
6 Britain and that the specific features objected to are two-fold - the Take or Pay charges and
7 the Premature Replacement Charges (the PRCs) in the MSAs. Those are features in the
8 legacy MSA agreement only. In the defence, at para. 357, which you can quickly flick to at
9 Tab 3 in the same bundle, on p.610 you will see what Ofgem has to say about the scope of
10 its finding. It sets it out and says,

11 “This is clearly a reference to the Legacy MSAs, not the N/R MSAs. The N/R
12 MSAs do not even include Take or Pay charges, and so the sentence would be
13 nonsensical if it included the N/R MSAs. Furthermore, it is clear from the focus of
14 the rest of the Decision in general, and in particular from the overview at para. 4.4,
15 that it is the early replacement charging arrangements in the Legacy MSAs which
16 give rise to the primary effects that are found to be abusive”.

17 That is how Ofgem describes its principal findings.

18 Its case in relation to the other MSA agreements - which are the New and Replacement
19 Agreements that National Grid was offering at the same time - is a general one. As you see
20 from the last sentence of para. 357,

21 It would be artificial to divorce the assessment of parts of the Legacy MSAs, or
22 indeed to entirely divorce assessment of the Legacy MSAs from the N/R MSAs, as
23 National Grid seeks to do”.

24 You see from that also that, likewise, Ofgem’s case in relation to all other parts of the
25 Legacy MSAs, apart from the two specific features which it has identified, is that those do
26 not give rise to the primary effects found to be abusive. Only one other aspect in fact is
27 dealt with anywhere in the Decision, as you will be aware, and that is the absence of
28 separate charging by National Grid for the provision of the meters on the one-hand and for
29 the maintenance of installed meters on the other. Ofgem’s approach to maintenance can be
30 found in the Decision, if you would go back to 4.182 on p.112 of the bundle, in tab 1 under
31 the conclusions on abuse. If you go there you see from the last two sentences of 4.182 what
32 it says is:

33 “It is not the Authority’s view that there is a separate “bundling” abuse, or
34 (therefore) that maintenance *necessarily* needs to be separated to bring the abuse

1 to an end. In the absence of other restrictive factors of MSA the requirement to
2 take maintenance from NG alone would not appreciably restrict competition.”
3 So it does not appreciably restrict competition in the absence of other restrictive factors.
4 Now, if you go back to the operative part of the Decision on p.130, paras. 2 to 4 are the
5 directions against which National Grid is appealing. You will see from those that the
6 operative part is ordering National Grid to put an end to the Take or Pay charges and the
7 PRCs within 90 days and refrain from conduct with the same exclusionary effect. You will
8 know that that aspect was suspended by the Tribunal by an interim order pending the
9 outcome of this main appeal.

10 We know that this does not mean refraining from using any kind of PRCs, in other words
11 charges which are triggered to compensate National Grid for any loss of future rentals if
12 meters are replaced early instead of the period committed to because Ofgem’s case is that it
13 is the structure of the PRCs which is objectionable and that a different structure of PRCs
14 would have been non-restrictive and normal competition. For that if you go to the defence,
15 in tab 3 again and go to p.556 and look at para. 175 you will see there it remains, they say in
16 the second sentence, the Authority’s case that in normal competition a meter operator might
17 adopt various methods to meet competition including up front payment, for example, when
18 you sell the meters, cancellation charges or adjusting the rental prices. What is not
19 acceptable is to levy cancellation charges in the form which National Grid has done with the
20 consequent foreclosing effects.

21 In the Decision (the main part of it) what Ofgem seeks to do is to demonstrate that point at
22 length because it compares the cost of replacing installed meters earlier than committed to
23 using on the one hand National Grid’s charges in the legacy MSAs and, on the other hand, a
24 system of age based charges. That is Ofgem’s counterfactual; its benchmark for showing
25 that National Grid’s charges lead to foreclosure.

26 The age based charges were consistent with normal competition and National Grid’s
27 charges were characterised in the Decision at numerous places with the label “artificial” ,
28 and I will just give you the references for that: 4.43 (third paragraph), 4.127 in the
29 conclusions, and also 4.123. The refrain is National Grid’s way of doing it was artificial.
30 Finally, para. 5 back on p.130, that imposes the penalty £41.6 million in respect of the
31 infringement identified in para.1, the two objectionable features. I would point out to the
32 Tribunal this is not on the basis that National Grid intended to restrict competition, what is
33 said is National Grid ought to have known that its conduct, the use of these early
34 replacement charges in the form found in the MSAs would foreclose the market and on that

1 basis what is said is National Grid is negligent and you see that if you go to p.118 in the
2 Decision, the second sentence says, and this is the way Ofgem saw it:

3 “On the available evidence and on the basis of reasonable inferences, the
4 Authority has found that NG ought to have known that the MSAs would have the
5 actual or likely affect of foreclosing the relevant market and that it has therefore
6 abused its dominant position negligently, rather than intentionally.”

7 That therefore represents the key findings that we are concerned with in this appeal. Having
8 said that I will now make six opening remarks about what we see to be fundamental aspects
9 of the case before I develop them more generally.

10 The first point: the new and replacement MSAs. This case, in our submission, does not
11 seriously concern the new and replacement MSAs at all. Despite the finding that the new
12 and replacement MSAs are abusive there is no feature within them which is objected to as
13 giving rise to an abuse. On the contrary in the Decision itself they are actually held up at
14 certain points by Ofgem as being a good example of the normal and competitive way of
15 doing things and if you turn, for example, to p.86 in the Decision and look at 4.89 at the
16 bottom of the page you will see that in developing its counterfactual of what would have
17 been normal and lawful, Ofgem refers to the contractual form used by CMOs, UMS and
18 National Grid in the NR MSAs.

19 THE CHAIRMAN: I am sorry, what page?

20 MR. TURNER: I am sorry, that was page 86. Just to avoid confusion, I am going by the big
21 numbering, which is the trial bundle numbering, there is also the internal numbering on the
22 Decision as well which is, in this case, on the right hand side of the page – “86” appears at
23 the foot of the page on the left hand side.

24 THE CHAIRMAN: So is the point you are making, Mr. Turner, that although in the operative
25 part on p.130 the paragraph that refers to long term meter supply arrangements for the
26 MSAs, in fact the abuse is limited to the legacy MSAs?

27 MR. TURNER: We say the abuse is strictly, yes, it is limited to the legacy MSAs, having said
28 that Ofgem persist for the reason I showed you in para. 357 of the defence in saying that the
29 new and replacement MSAs are brought into the abuse because it is entirely artificial to
30 divorce them is the way that it is put. My point is that they do not object to any feature
31 within them which is itself objectionable. The only way in which they are drawn into the
32 abuse beyond the vague statement in the defence which you have already seen, is because of
33 this, gas suppliers rent meters on the new and replacement MSA terms when their meters
34 are replaced by National Grid after maintenance visits. I think that is the only way in which

1 you find in the Decision that they come into the story at all. We will be saying that because
2 there is nothing objectionable about those agreements in themselves it is wrong to regard
3 them as a part of the abuse as unlawful and therefore the new and replacement MSAs can,
4 as far as we are concerned be put to one side and I intend to focus on the Legacy MSAs.

5 THE CHAIRMAN: Yes, and it is not clear whether the putting an end to an infringement that you
6 have been directed to do requires any change to the new and replacement MSA, or only
7 requires a change to the Legacy MSA.

8 MR. TURNER: We go further, not just saying it is not clear. There is no reason offered as to
9 why one would have to do that. So we say you can put new and replacement MSAs to one
10 side.

11 My second point, pre-payment meters: this case, in our submission, does not concern pre-
12 payment meters otherwise. If you turn to tab 20 in the second core bundle, CB2, and look
13 at the statement of facts, the position on pre-payment meters, which happily is almost all in
14 green text, is at paras.9 to 15. Very broadly, there are two main types of domestic size gas
15 meters. There are credit meters, what we call DCMs, and the pre-payment meters, which
16 have been called PPMs. The PPMs, it is uncontroversial, account for about 10 per cent of
17 the installed stock. That means roughly 2 million out of the 22 million in households up
18 and down the country. Both of these kinds of meters are covered by the legacy MSA
19 agreements. Both of these kinds of meters are subject to the exactly the same form or
20 structure of charging for PRCs and the like, which Ofgem has found to be foreclosing and
21 artificial.

22 In the case of the PPMs, where there is a much shorter glide path, it is only seven years,
23 after which there is no further commitment to rent any of these installed meters, as opposed
24 to 18 years for the credit meters, and where the PRCs are all so much smaller in relation to
25 the costs of purchasing and installing new PPMs, Ofgem's Decision, we say, does not find
26 any foreclosure to have happened.

27 May I take you to a few references. Would you now go back to the Decision in CB1, and
28 you can put away CB2 for the moment. If you turn first to paras.4.65 in the Decision to
29 4.67, in the external numbering that is p.81, there is a heading, "The level of NG's PRCs".
30 4.65 tells us that under the Legacy MSA, National Grid is applying:

31 "... average PRCs regardless of the age or year of installation of the meter in
32 question, although a separate average is set for the DCM and PPMs.

1 For the first year of the Legacy MSAs, the DCM PRC was set equal to £57 per
2 meter, regardless of age or year of installation although nothing can increase this
3 PRC if it decides that a supplier has replaced too many young meters.”

4 Then they say this:

5 “This level of charge is high relative to the commercial benefits that gas suppliers
6 would expect to obtain from switching to a cheaper CMO (or UMS) ...”

7 That is the National Grid owned operator –

8 “ ... and will reduce their incentive to switch. Because PRCs far exceed the annual
9 rental cost payable – for example, about £11 a year for the rent of a DCM – this
10 switching cost is likely to exceed the present value of the commercial benefits of
11 switching to a CMO using the same metering technology as nothing.”

12 They qualify that, and we are now only on the credit meters.

13 “PRCs at this level might arguably be justifiable for only new or nearly new meters
14 (as the purchase and installation cost of buying a new DCM is £70-£80). But as
15 explained in Chapter 2, a significant proportion of the NG’s legacy meters are old
16 and were installed many years ago. As an example, in December 2005 over 5
17 million of the 15.7m DCMs were over 15 years old.”

18 That is their case on the DCMs. Then we turn to the PPMs.

19 “For the first year of the Legacy MSAs, the PPM PRC was around £37. This
20 represents a much lower proportion of the average cost of purchasing and installing
21 a new PPM (around £170-£200) or the cost of installing a refurbished meter
22 (around £100-£110).”

23 That is all they say about it. They then go on with a qualification:

24 “But, as explained above, NG has announced its intention to ‘re-balance’ PPM and
25 DCM charges. This would result in a significant increase in the level of PPM
26 PRCs but only a very small reduction in the DCM PRC because of the much
27 higher number of DCMs relative to PPMs. The re-balanced PRC for 2005/06
28 would be around £78.”

29 Standing back, what they do here is to identify that for the PPMs the charge is much lower,
30 there is not the same analysis that you have just had for the credit meters about how this
31 may be expected to cause foreclosing effects, and the “but” in that sentence seems to say
32 that if certain circumstances arise, which is this re-balancing, then you would get, implicitly
33 at any rate, these problems, the foreclosing effect.

1 That is the way it seems to be put, and by the way I would say at this moment that we
2 actually contest, as mistaken, this point that National Grid has announced its intention to re-
3 balance PPM and DCM charges as though this is its continuing intention. It is said in the
4 Decision, para.2.37 (I think) that we continue to inform our investors that this is the case.
5 Ofgem were told that that is not the case. It was originally said that is true. We have since
6 put that on ice as a result of this investigation.

7 Just to put in context the way in which they say that this foreclosure arises with these PRCs,
8 would you mind picking up bundle CT1 because that contains the contracts. Would you
9 turn to tab 2. You will have a copy there of the Legacy MSA contract, a conformed copy
10 for illustration purposes only. Would you go to p.432 and 433. What you will see there is
11 the charges. These are the PRCs. On the left hand side you have the 18 year flow of
12 charges for the credit meters. It was inflation point. Ofgem say £57, whereas it says here
13 £58.44. That is not material, but it starts for year 1 on the credit meter side at £58.44. You
14 will see that that PRC level goes down every year of the 18 year contract, until in the last
15 year, if you wanted to take out any meters above the glide path amount and beyond the BLR
16 band, you are talking about a charge of £1.19. That is the credit meter side.

17 If you look at the facing page, you have got the pre-payment arrangement. You will see
18 there that it is much shorter, seven years, before all of the stock can be taken out. The
19 starting PRC amount is, as Ofgem say, rightly, much smaller, £37.95 here. You will see
20 how rapidly it decreases down to £1.74 after only seven years. You will be aware that we
21 are already, if you look at the dates there, in year 4 of the contract.

22 THE CHAIRMAN: What is the "PCredit" column?

23 MR. TURNER: That is the alternative PRCs which would be applicable if a disproportionate
24 number of younger meters were removed, which, although Ofgem refers to this in the
25 course of its Decision, form no part of the reasoning in the case, as Mr. Keyworth, we will
26 see if we need to, points out in his report. So far as you are concerned, it is the central
27 column which sets out these flat rate PRC amounts and shows you how they work.
28 That is what Ofgem said about the PRCs and their impacts for PPMs in the Decision and
29 what it did say about the impact of the Take or Pay charges and the glidepath more
30 generally, which is the only other place it deals with PPMs. If you put away CT1 now, and
31 go back to the Decision, and turn on a few pages to para. 4.79 at p.85 of the external
32 numbering -- There is a very short heading 'Prepayment Meters'. This is actually all there
33 is, together with an annexe which supports it. What you will see is that they say they have
34 carried out a similar analysis to assess the cumulative cost of replacing more PPMs than

1 permitted by National Grid's glidepath. This is similar to the analysis that they carried out
2 for the credit meters where they assume an extra half a million a year above the glidepath
3 taken out for the first three years. So, they say, very shortly, "We did the same thing for
4 PPMs". They report the results back in Annex 4. What they say in 4.80 is,

5 "The Authority concludes that given relevant differences in the factual context
6 within which the charging provisions related to the replacement of PPMs apply,
7 the impact of these provisions on the costs to a supplier of replacing more meters
8 than scheduled by National Grid under the Legacy MSA is likely to be less
9 pronounced than is the case for DCMs".

10 Then, instead of the 'but' we now have a 'however'. "However, National Grid's proposed
11 rebalancing of charges, as described above, would significantly increase the cost of PPM
12 replacements in excess of those permitted by the glidepath, and thus the costs of switching
13 out National Grid's PPMs".

14 Now, as we read that, again, what they are saying is, "We are not fighting positively that the
15 structure of charges adopted by National Grid in the Legacy MSAs has these foreclosing
16 effects so far as the prepayment meters are concerned". They use the words 'likely to be
17 less pronounced'. I gather from my friend's skeleton that they say that that means there is a
18 positive finding. We say it is far from saying that there is a positive finding.

19 THE CHAIRMAN: How would it work contractually? You have just shown us that in the
20 contract it sets what the PRC is at £37. Is there something in the contract which enables
21 you to change that to £78 if you decide to rebalance your charges?

22 MR. TURNER: I have to try and remember this precisely. I think it is Schedule 7, Part 4, para. 3
23 of these awful contracts..

24 THE CHAIRMAN: That sounds pretty precise.

25 MR. TURNER: That tells us about the circumstances in which rebalancing can take place. They
26 are quite complicated. Ofgem consulted on the proposal by National Grid to rebalance its
27 charges when that was announced back in 2005. The position is that in order to re-balance
28 you would either need, without any change in structure Ofgem's consent because the reason
29 why you have the structure at the moment is that the prepayment meters cannot be charged
30 out at more than a tariff cap imposed by Ofgem, which holds the cost of provision of the
31 prepayment meters below their full cost of provision. Instead, the credit meters bear that
32 cost. The tariff cap for the credit meters has been correspondingly increased by Ofgem to
33 allow for that.

1 So, either National Grid would have to have Ofgem itself re-adjusting the tariff caps or
2 there is provision for National Grid under these contracts to be able to move the contracts
3 into an unregulated company, which was originally the intention - the way in which this was
4 going to happen - and then National Grid Metering - the regulated entity - would be joined
5 together with UMS (the currently unregulated entity), and it was in relation to that proposal
6 that you should move these contracts to an unregulated new entity that there was the
7 consultation and then National Grid put its proposal to do so on ice. But, it is not a
8 straightforward, instant thing which could be achieved.

9 THE CHAIRMAN: Contractually there is an ability ----

10 MR. TURNER: There is a mechanism

11 THE CHAIRMAN: -- if that were to take place, then the counterparty to the Legacy MSA cannot
12 say, "Oh, well, it says here £37" and you are stuck with £37. There is a mechanism for you
13 to vary that in the event of something more specific ----

14 MR. TURNER: Yes, that is right. In the event of a novation of the contract to a new entity, then
15 that could be done.

16 PROFESSOR STONEMAN: I want to take note of two points you have made so far. The first
17 one is that you are arguing that the Ofgem case is that for DCMs the problem is the
18 structure of the MSA contract for ... meters against the structure that is being objected to.

19 MR. TURNER: Yes.

20 PROFESSOR STONEMAN: What you are now arguing is that Ofgem argue that because the
21 quantities are smaller, or the prices and costs involved are smaller with respect with PPMs,
22 then the structure does not matter. Is that what you are arguing?

23 MR. TURNER: Now, the way that you put it is: Is this what I am arguing? What I am doing is
24 showing you what the Decision says is what they are arguing.

25 PROFESSOR STONEMAN: That is how you are interpreting what they are arguing.

26 MR. TURNER: Exactly. That is how we interpret it. Their objection essentially is to the
27 structure that was used, which is common to both of the DCMs and the pre-payment meters
28 as common. What I am attempting to show you now is that when you talk about the
29 prepayment meters, interestingly-enough in the Decision, this structure, for the reasons that
30 they give, is not actually found to have these foreclosing effects. If I may anticipate, sir, I
31 think that does point up a point that we will be making - that in fact you cannot therefore be
32 saying that the structure itself is, for some reason, inherently problematic.

33 PROFESSOR STONEMAN: So, in a way, what you are addressing to us in para. 4.80, with the
34 words 'less pronounced' is how we should interpret the words 'less pronounced'.

1 MR. TURNER: Yes. That is a point of dispute. The words ‘less pronounced’ are actually also
2 followed up with Annexe 4 which perhaps you ought to look at as well because that is what
3 is referred to where they say they have carried out their analysis of the effects for PPM
4 replacement. If you have a look, this is their analysis. Paragraph 3 in Annexe 4, on p.135,
5 says that,

6 “Unlike with DCMs, PPM replacement is not likely to give rise to a long period of
7 payment of Take or Pay charges. This is because a supplier’s ability to leave the
8 Take or Pay Zone would be much less constrained than is the case for DCMs as
9 the number of policy replacements and maintenance replacements is much lower”.

10 Then they refer to the total costs. That is all that is said there. Then that supports the
11 conclusion you have got in 4.80 that all they say is ‘less pronounced’. We say that that is
12 not a finding. Our interpretation is that what Ofgem is saying with its ‘but’ in para. 4.67
13 and its ‘however’ in para. 4.80 is that things could change in the future with PPMs if
14 National Grid were to rebalance the charges which it has not done, which it has told Ofgem
15 it is not presently intending to do, and which it might never do. I can give you the
16 references for these if it should prove necessary.

17 Drawing those strands together then I say this: Ofgem’s case in the Decision turns out, on
18 inspection, to be extremely narrow. It is that the structure of the early replacement charges
19 in the Legacy agreements for the already installed credit meters (the DCMs) is the alleged
20 vice.

21 THE CHAIRMAN: But you are not arguing that DCMs and PPMs are in a separate market from
22 each other, so does it make sense then to try and distinguish the foreclosure effect in relate,
23 because foreclosure is foreclosure preventing people from entering the relevant market.

24 MR. TURNER: Absolutely.

25 THE CHAIRMAN: If there is no separate relevant market for DCMs and PPMs I am not quite
26 clear what your case is on foreclosure then.

27 MR. TURNER: What we are saying is this: yes, you can talk about one economic market which
28 includes the DCMs and the PPMs together. Ofgem in its Decision is looking at aspects of
29 these agreements which it says forecloses entry to that market artificially and what I am
30 pointing out is that when you inspect their reasoning the root of foreclosure, the block
31 comes in relation to the credit meters only. They are not saying that the way that these
32 contracts are working are blocking any possibility in relation to the early replacement
33 charging arrangements blocking a path of entry for the prepayment meters. That is the way

1 it is. Now, that is my attempt to try to focus for the Tribunal the essential structure, the core
2 logic of the Decision.

3 What I would like to turn to now is the critical importance of the factual and economic
4 context; this is, as it were, my third opening remark. The Tribunal knows that it is well
5 established and it is common ground that we all have to pay close attention to the factual
6 and economic context before we conclude that certain behaviour has resulted in anti-
7 competitive foreclosure, and by that means (because this is what the competition rules are
8 about) harm the interests of customers and consumers. In that connection there are
9 distinctive features of this industry which we say will be fundamentally important to your
10 Decision and these include: first, the characteristics of the business meter provision, which
11 makes it normal for providers to compete against each other on the basis of long term rental
12 agreements with cancellation charges, what we have been loosely calling “term
13 commitment”. That is not a block to competition, you should think of it as the way in
14 which competition happens in this market.

15 THE CHAIRMAN: Sorry, could you just say, on basis of long term rental agreements, which
16 include cancellation ----

17 MR. TURNER: Which include cancellation charges. If you like you can think of a subtext which
18 we will try to draw out in this case, as two competing visions of competition. On the one
19 hand, short term competition, a spot market – is that meter cheaper than this installed one on
20 a year by year basis? If so competition says you ought to be able to take out the existing
21 one, put in the new slightly cheaper one, that is competition.

22 Our vision of competition is slightly different, that when you are sensitive to what you have
23 in this case, these long lived assets and the sunk costs and all the rest of it, the way in which
24 competition works with meter providers includes National Grid, Capital Meters, Meter Fit,
25 UMS, is that it is normal to put in place agreements to compete to provide gas suppliers
26 with agreements which contain some guarantees, these long term cancellation charges. It is
27 a different vision of competition and we say it is a valid vision and that is how competition
28 works in this market. Although Ofgem say “we accept ...” and I have shown you some
29 references, “that that is normal competition, another part of its way of arguing the case pulls
30 against that because at times in the Decision, in the defence in the skeleton, it seems to be
31 saying: “That is not competition.” Competition should be that you can drop your prices
32 with no term protection in response to a threat that somebody else has a cheaper meter out
33 there which might replace it, without reference to these cancellation charges.

1 PROFESSOR STONEMAN: Could you clarify for me whether you are using the word “normal”
2 in the lay sense or “normal” in the technical sense?

3 MR. TURNER: I hope I am using it in both, sir. When you say the “technical” sense, we say that
4 this is a normal way of competing, given the circumstances of this market. Yes, it is
5 “normal” in the lay sense, you will notice that so far as the economist experts are concerned,
6 as well as the position taken by the parties that both Professor Grout for Ofgem and our
7 expert, notably Dr. Williams for National Grid, say that from an economist’s perspective
8 this is normal competition as well, so we are using it in both senses.

9 The second matter that is going to be very important, we say, to your ultimate decision on
10 this is that you will need to appreciate that these are commercial agreements which were
11 made at a particular moment in time, that is the transition within the metering industry from
12 a regulated monopoly to competition. Our case, as you know, is that under the regulated
13 monopoly situation the rules of the game were in a sense abnormal in a lay and in a
14 technical sense; and that these agreements were negotiated moreover against the backcloth –
15 the continuing backcloth of the regulated contracts which National Grid had to continue to
16 offer to all its customers.

17 For those points, if I may direct the Tribunal to pick up CB2 again, you will find the most
18 succinct summary of our position – as good for you now as it has always been – in our reply
19 at tab 7 of CB2, beginning at para.5, and if I may just take you briefly through that section it
20 is the easiest way to make my points. Paragraph 5 begins on p.679 of the external
21 numbering under the heading what this case is about and why Ofgem is wrong. Paragraphs
22 5 and 6 refer to the case that typically in this market, although you expect many assets with
23 the characteristics of meters to be sold you find that these assets are rented to the gas
24 suppliers and the quotation in para. 6 from the first SO tells you that this is in part because
25 the gas suppliers do not like tying up their own capital by buying these meters when there
26 might be a change of gas supplier.

27 Paragraph 7 tells you that it is a sunk cost business because of course you have to have the
28 labour around to install it, that costs a lot of money, it is sunk, it is irrecoverable, and the
29 capital cost of the meter itself is in a large number of cases also irrecoverable once the
30 meter has been installed.

31 Paragraph 8 draws the conclusion that because of those things it is normal for there to be a
32 rental payment arrangement, and it is also a normal method of competition at any rate to
33 arrange for the agreed value of the payments to be completed one way or another if the gas
34 supplier wants to take the meter out early.

1 Then you get on to the heart of what we say was the dynamics, the story. Paragraph 9 that
2 in 2002 you had a genuine economic problem affecting the interests of consumers and the
3 overall efficiency of the market place.

4 Paragraph 10:

5 “The problem arises because:

6 There was a significant economic cost associated with the replacement of
7 installed Meters prematurely (i.e., while they continued to function
8 effectively). The paper prepared for Ofgem’s management committee
9 dated 5 February 2003 summarised this issue:

10 ‘In May 2002 (May 2002 Metering Strategy – Progress and next
11 steps) Ofgem identified concerns about the removal of meters before
12 the end of their useful lives (referred to hereafter as premature
13 replacement) on the grounds it was economically inefficient and led
14 to unnecessary disruption to consumers’.

15 Then the problem is, as in (b):

16 “Yet under the arrangements prevailing at the time, gas suppliers had an artificial
17 incentive to replace installed Meters prematurely where there are any benefits to
18 them.”

19 The replacement meters are slightly cheaper –

20 “... even if the installed ones are functioning perfectly well, and even if the
21 benefits to the gas suppliers were very small indeed.”

22 This was because they do not face the normal discipline, we say, of an obligation to
23 complete payment for the meters which have been provided. So the gas suppliers, the
24 customers, are facing the true economic cost of their own decision about replacing the
25 meters prematurely.

26 THE CHAIRMAN: What you are saying here is that in the contracts which prevailed before the -

27 ---

28 MR. TURNER: The MSAs.

29 THE CHAIRMAN: Not just before the MSAs, but before the whole move into opening this up
30 for competition, what were the features of those contracts where they did not separate out
31 the metering from the transport of the gas – is that right? As far as these aspects are
32 concerned, were they long term contracts without cancellation charges, or how did that
33 work?

1 MR. TURNER: Originally gas transportation and metering charges were all together, so that
2 there was a single charge made. I believe that situation remained until the year 2000.
3 Thereafter metering charges are separated out. By the way, still today, under the regulated
4 arrangements for charging for meters, maintenance and provision, there is a single charge,
5 but metering is now separate from transportation.

6 The industry got together on a multi-lateral basis with Ofgem participating and agreed a
7 new form of contracts called the RGMA contracts, review of gas meter arrangement
8 contracts, or as they are now known and referred to by the parties, P&M contracts,
9 provision and maintenance contracts, under which the charges that are made for the meters
10 are tariff capped. You cannot charge for the pre-payments above the constrained tariff cap,
11 and nor can you charge for the credit meters above that tariff capped level. You can remove
12 the meters if you are the gas supplier under those contracts with no notice at all.

13 THE CHAIRMAN: That is what struck me as slightly odd about these P&M contracts, that they
14 were drafted in the context of the knowledge of the industry that competition in metering
15 was going to be introduced, yet they have this characteristic, which you say is abnormal
16 competition, of not preventing premature replacement, or not providing a disincentive of the
17 premature replacement. I can understand how that would come about if the P&M contracts
18 dated back to the 1960s or whatever, before anybody thought that competition in metering
19 might be introduced, but it is rather curious that they came up with that contract following
20 the RGMA.

21 MR. TURNER: It was a flaw. That was what happened. As part of the story you will see that
22 once National Grid cottoned on to the fact that there was this issue now, that gas suppliers
23 could begin to tender for competitive metering provision and that the new providers,
24 Meter Fit, and so on, could pull out the existing installed meters and put in slightly cheaper
25 ones where it was of any benefit to the gas suppliers, this issue came into focus. What is
26 agreed between the parties is that the way it first came into focus is that National Grid
27 realised there was this issue and the negotiations with Ofgem about it first began with an
28 attempt by National Grid to get a change to the regulatory system, an amendment to the
29 Network Code, so that this problem would be corrected within the regulated contract
30 structure.

31 Ofgem was not happy with that. After about February 2003 – Ofgem says February 2003,
32 we say it was earlier, December 2002 – the focus switches so far as National Grid is
33 concerned from instead of trying to arrange for a change to the regulated system to
34 accommodate this problem, to deal for private commercial contracts alongside those

1 regulated arrangements. You will see from the story, and you will hear from the evidence
2 that this is first brought to Ofgem's attention and talked about, I think, in December 2002,
3 and then the idea of the Legacy MSAs as being a separate commercial arrangement outside
4 the regulation takes off. So at that point it splits off.

5 Returning then to the Reply, which I hope you have still got in front of you, para.11 refers
6 to the point that this problem which was perceived to:

7 " ... raise industry costs and harm consumer interests, was a matter of concern to
8 Ofgem at the time."

9 They give a reference to certain documents in the notice of appeal, and subsequent to the
10 notice of appeal Ofgem disclosed further internal documents. I have quoted there three of
11 those. You will see (a) an email from Miss Frerk:

12 "...the problem that we are worried about is that of inefficient switching ..."

13 A brief to the chief executive in October 2002 about discussions with National Grid and the
14 regulator:

15 "*Ofgem's objectives in reaching a conclusion on this are ... to avoid artificial or*
16 *uneconomic competition ...*"

17 Then an internal email, Miss Frerk, October 2002, in which she said:

18 "*[Eileen Marshall] didn't accept that premature replacement was inefficient and*
19 *said it was efficient if the replacement meters were cheaper ... I said it wasn't*
20 *efficient given that the in situ meters were of sunk cost ...*"

21 There was an internal dispute about. That is what we say was the abnormal position.

22 You then have National Grid, we refer to in para.12, with its only incentive, to bargain to
23 keep its installed meters in place while they functioned perfectly well, to try to get back as
24 much of its sunk costs as it can.

25 Then 13 makes the point that you see these two different incentives, as it were, and it is
26 natural for the parties to try to get together and sort out a commercial bargain. We say:

27 "The joint interest of National Grid and the gas suppliers was to agree to an
28 efficient industry outcome, and the gas suppliers saw an opportunity to extract
29 better overall terms from National Grid."

30 I set out an extract from Ofgem's assessment in February 2003 in its management
31 committee paper:

32 "Informal discussions with suppliers [gas suppliers] suggest they welcome
33 Transco's proposals as bringing down prices in response to competition while still

1 allowing the flexibility to install meters provided on a competitive basis at broadly
2 the rate they would have done anyway ...

3 Allowing Transco [i.e. National Grid] to sign commercial contracts would seem to
4 be the most effective means of ensuring an efficient industry outcome. Transco's
5 licence requires them to provide meters upon shipper request and these meters
6 would be provided on the current price controlled terms with no premature
7 replacement charge unless a shipper requested otherwise. This weakens the ability
8 of Transco to abuse market power in setting terms of its metering contracts since
9 the regulated default option is always available."

10 At para.14 I draw out what we say are the key points that Ofgem is recognising there.

11 Number 1, our proposals bring down prices:

12 ... in response to competition ..."

13 means it is competition, the bargaining process was an act of competition.

14 Number 2, you see it was gas suppliers who made their own individual assessments of the
15 benefits for them and their customers, the gas consumers, in view of these reduced price.

16 Number 3, a point which drops out of Ofgem's reasoning on market power in the Decision,
17 that the gas suppliers are all bargaining with this outside option there of remaining on the
18 default regulatory terms, so that any new contract, at least so far as they are concerned, has
19 to give them better terms. I make the point that one of the five or six major gas suppliers,
20 EDF, says, "We are not going to accept that. We are perfectly happy to stay on the regulated
21 terms".

22 Then, finally, para. 15 before we return to the fray. The outcome. National Grid agreed to
23 rent the installed meters, including the early replacement charges, as you know, at prices
24 which recover several hundred million pounds less than the sunk costs of the assets. By that,
25 what I mean is the unrecovered costs of the past investments in metering and taking account
26 of the extent to which these assets could be re-used or sold for scrap.

27 Ofgem's original case, I mention here, was that these contracts were objectionable in part
28 because they secured recovery of the entire regulatory value of the assets.

29 THE CHAIRMAN: Is what you are saying in A then that if these contracts had been allowed to
30 play out for the eighteen years for the DCMs without any BLR or PRC being paid by the
31 gas suppliers -- Suppose the gas suppliers had just accepted it, hook, line and sinker, and
32 decided they were just going to replace exactly the number that were allowed. At the end of
33 the eighteen years you would not have recovered all your costs.

34 MR. TURNER: Yes.

1 THE CHAIRMAN: Have you factored into that the continued payments for more than eighteen
2 year old meters?

3 MR. TURNER: For more than eighteen year old meters?

4 THE CHAIRMAN: Yes - meters that you keep for more than eighteen years. If you have a
5 twenty year old meter ----

6 MR. TURNER: Oh, yes. Absolutely.

7 THE CHAIRMAN: You still pay the rental on it.

8 MR. TURNER: Absolutely. The point of these contracts is that over a timeframe of eighteen
9 years progressively you are committing to rent a certain minimum number, and by the end
10 of that period there is no more commitment, no more guarantee. All of it is completely free
11 to replace. The assumption, which is an assumption that National Grid made in its own
12 internal business plans is that that is exactly what would happen in the competitive metering
13 market. So, what it was bargaining with these contracts, to get the gas suppliers to commit
14 to, was a recovery of money that was a lot less than the sunk costs of its investment in the
15 meters. Moreover, the idea behind these payment completion arrangements was that
16 National Grid is not better off if it does replace these meters early - so that if the gas
17 suppliers decide, "Well, actually, we'd like to take out far more of these meters than is
18 envisaged by the glidepath early" -- You will see in a moment that the thinking of National
19 Grid was, "We want to arrange a structure of charges that just means that National Grid still
20 remain in the same position - they are not worse off". That was the point. That is why we
21 call them payment completion arrangements.

22 THE CHAIRMAN: So, working on the plan that that is what would happen - that at the end of
23 the eighteen years all the Legacy meters will have been replaced -- some of those will have
24 been replaced by National Grid with its own meters, but then a further installation cost will
25 have been incurred which is then recovered through the other contract.

26 MR. TURNER: In the case of the gas suppliers who have signed the Legacy MSAs - as opposed
27 to EDF who stands outside - they obviously have, under the MSAs, this freedom to elect
28 their own commercial meter operators to take out the installed meters and to put in new
29 ones. Whether it is National Grid or UMS which does that, or somebody else, is irrelevant,
30 in a sense, because then any charges that arise - any contractual protection - accrues to the
31 new meter which comes in. The old meter has gone, and either you have got your money
32 by way of the rental term or, if it has been taken out early you have received a charge, the
33 overall effect of which is designed to keep you neutral.

1 You have to bear in mind also that the way National Grid sees these arrangements is that it
2 is renting a portfolio of meters to the gas suppliers. It rents a minimum number over the
3 period. The commitment progressively declines to zero.

4 Now, Ofgem says, on that note, that what National Grid is saying somehow in its case is
5 that it was entitled to receive some income - entitled to recover the regulatory value. Well,
6 that is not the case because we are recovering a lot less than the regulatory value. What we
7 are saying only is this: that where we have made normal payment completion arrangements
8 we are entitled, through the charges to recover the income that we have agreed to with the
9 gas suppliers by way of their rental commitment - and nothing more than that. Ofgem has
10 now clarified this absolutely explicitly: nor is this an excessive pricing case. They are not
11 saying that either the PRCs or however the early replacement charge is arrived at, or the
12 rentals, are excessive in any way.

13 So, the point is that as a result of this act of competition the gas suppliers go forward with
14 this large benefit which you can expect then to be passed through if the competition at their
15 level is competitive to gas consumers.

16 The second point, at 15(b), is this: I would ask the Tribunal to focus on certain features of
17 these agreements. With your permission I will not take you through the contractual
18 documents themselves. If it is a matter of dispute we can, but it is quicker not to.

19 “-- Provision for a substantial proportion of charge-free replacement (above
20 historic levels), and early replacement charges which, in the explicit assessment of
21 the customers ... had the benefits of operational flexibility (for the gas supplies and
22 their CMOs) as well as simplicity; and (iii) were fully compatible in the eyes of
23 the customers with the roll-out of new technology in future years”.

24 I just want to make four additional points there: (1) that Ofgem has sometimes presented
25 this case, as have the interveners as though National Grid entered into eighteen year
26 contracts for its Legacy meter stock. Of course, that is not true. It is not eighteen years for
27 all of these meters that they have to stay in place. It is a progressively declining number. To
28 call them eighteen year contracts is therefore, in a sense, misleading. (2) These charges, as
29 you saw from the sheet that I took you to a little while ago do not stay at that £57 level each
30 year of the contract. They fall each year of the contract until eventually they come down to
31 zero. (3) Although Ofgem says, “Well, it’s customary in this industry to think of credit
32 meters having a twenty year useful life, and although the CMO contracts have worked on
33 recovering their charges over a twenty year period, and although National Grid’s meters on
34 the walls in the Legacy arrangement will range in age [I will come to this in a moment]

1 from very, very young, just newly installed, all the way to very, very old, these are only an
2 eighteen year contract - a shorter period of commitment than the CMO contract ... of its 20
3 year life”.

4 Point no.4, a very important point, that these contracts do not just allow enough flexibility
5 under the glidepath to replace the same number of meters which we say is consistent with
6 the organic natural pattern of replacement, namely, when meters become faulty or they are
7 inaccurate and they need to be replaced, you take them out and you put in a new one, or
8 indeed where the gas supplier says: “For my own reasons I want this customer to have a
9 prepayment meter because they are not a good credit risk so I am going to swap the credit
10 meter for a prepayment one.”

11 The glidepath allowance allowed for all of that, 980,000 meters a year, and more – 130,000
12 on Ofgem’s own assessment out of the 980,000. The 130,000 meters relates to the freedom
13 to take out fully functioning working meters if you want to, and replace them with cheaper
14 meters. Those are four very important aspects of the arrangements which are now
15 criticised.

16 MR. SUMMERS: Mr. Turner, could you just help us to understand what happens at the end of 18
17 years if a meter is still functioning and has not been replaced, what form of contract then
18 applies? You talk about 18 year contracts but obviously I think we have read in the
19 evidence that these meters may go on for 25 years.

20 MR. TURNER: Absolutely.

21 MR. SUMMERS: So what form of contract applies at that point?

22 MR. TURNER: Well it is the same form of contract. The point is that the commitment to rent
23 has disappeared, which means that the gas supplier is renting the meter at whatever the
24 applicable charge is, but is completely free to take the meter out and to replace it at that
25 stage with a cheaper meter from a competitor, or from National Grid if it wants to do that,
26 and that is exactly the same as you would find in the CMO contracts where, at the end of
27 their period (the 20 years that they apply) the customer (the gas supplier) is entirely free to
28 do exactly the same thing. By the way I can show you, if it should become necessary,
29 another interesting feature of at least one of the CMO contracts is that there is a provision
30 saying at the end of that period the parties can enter into good faith negotiations to discuss a
31 further period of commitment for fully functioning meters which continue to be rented,
32 which gives you some indication that that protection for fully functioning meters is a good
33 example of normal competition.

1 THE CHAIRMAN: So are you saying then that the legacy MSA could actually continue to run
2 after the 18 years but that those provisions which deal with the PRCs will then be
3 redundant, or will have expired, that if the meters have not been replaced, either by another
4 National Grid or by a CMOs meter they will continue to be governed by the legacy MSA,
5 but can be replaced without any harm under that contract?

6 MR. TURNER: Under that contract. That is the formal position. It is likely, of course, partly for
7 the same reason that I mentioned a moment ago in relation to the CMO contracts, that in
8 those circumstances the parties would renegotiate. National Grid says: “We are continuing
9 to rent this meter at this price with no protection, you can pull it off the wall again and put
10 in a slightly cheaper meter”, and the parties could again get together and renegotiate a
11 further period of term protection, but the important point is that as you correctly say, the
12 legacy meter charges then trundle on subject to any renegotiation but with no commitment
13 by the gas supplier at all in the form of needing to pay an early replacement charge after that
14 time.

15 THE CHAIRMAN: Just wait one moment, Mr. Turner.

16 (The Tribunal confer)

17 THE CHAIRMAN: I think we will take a short break for five or ten minutes.

18 MR. TURNER: Yes, of course.

19 (Short break)

20 MR. TURNER: Madam, my team took advantage of the short adjournment to draw to my
21 attention a small number of points which I will mention. If you have CB2 there, this relates
22 to your question about the regulatory contracts, and go to the statement of facts, tab 20 at
23 para. 55 on p.30 of that tab, it is in green. That is picking up exactly what Ofgem said in the
24 first SO:

25 “... the P&M contract was developed multilaterally by the industry as part of the
26 RGMA process.”

27 The terms are explained a little bit above.

28 “... (covering domestic and I&C meters). Of importance the P&M contract contains
29 arrangements similar to those which had existed within the Network Code ...”

30 before there were contracts,

31 “... which allows gas suppliers to replace National Grid’s meters effectively
32 without notice and without compensation.”

33 I may as well mention also, you will see from para.56 that part of Ofgem’s vision of
34 competition you need to see is the “supplier hub principle” which is where the gas suppliers

1 determine who should fit the meters, as well as the rate at which such meters and/or new
2 technology was brought into the market. That text is agreed.

3 Paragraph 57 tells you that there is this continuing licence obligation on National Grid to
4 provide and install a meter if requested to do so. What I am told is that from that network
5 code obligation of National Grid to provide the meters on those terms, the contracts which
6 came out of that, the regulatory contracts (legal contracts) were a lift and shift exercise.
7 They were part of the transition to try to put in place the building blocks by which then
8 competitive metering would take place. It was not therefore a contract determined by
9 competition, it was part of the arrangements in the industry to move to a structure where
10 competition could then take place.

11 I am also told that although I said December 2002 as the time when National Grid said:
12 “Hold on a moment, we are going to need to include some early replacement charging
13 arrangements here as well, the first signs of discussion about that with Ofgem date back to
14 September 2002, for your note.

15 The other point of clarification is that you referred, madam, to 18 year old meters and what
16 happens to them at the end of this period. Just for pure clarity, under the Legacy MSA
17 Agreement, it does not matter what the age of the meter is which you take out at any stage.
18 Some of these meters, as you will know, and you will see in a moment can stay in place for
19 a long time without any problem at all, and it does not matter under the legacy MSA
20 arrangements where, in year one, let us say, when you have got this allowance, you take out
21 a very old meter, or a very young meter it is entirely at the discretion of the customer what
22 they do; it is not referable to the age of the meter at all at any point.

23 The last point on this page, and the last point I need from this reply is the observation that,
24 as a result of the outcome of all of this, even if you leave UMS, the National Grid identity
25 out of account, you focus only on the new rivals to National Grid in the broad sense. They
26 got a 33 per cent market share nationally of the flow of new and replacement work within a
27 space of, at most, only three years, and if you bring UMS into that picture, that climbs to
28 around 55, 56 per cent. I will show you the tabulation of that shortly.

29 My fourth opening remark is to comment briefly on Ofgem’s radical shift of position in this
30 case since the date of the Decision. Our case is that Ofgem has shifted its ground since the
31 Decision fundamentally. By the time we move to the defence to our notice of appeal, the
32 age related counterfactual you find in the Decision has been downgraded. It is now called
33 the “Alternative counterfactual”. The emphasis that you find in Ofgem’s defence, and even

1 more strongly in this recent skeleton argument of theirs, is on what it calls its “no PRC
2 counterfactual”. For your note we deal with that in the reply at paras.90 to 95.

3 The other counterfactual, the no PRC counterfactual, is never referred to as such in the
4 Decision, as you know. It is the hypothetical situation in which no deal has been reached
5 between National Grid and the major gas suppliers at all, and everybody continues dealing
6 on the price regulated terms.

7 If you would open up the defence at tab 3 of CB1 at para.35. You see the way in which the
8 matter is put there, p.511 of the bundle numbering. At the foot p.511 there is a heading
9 “PRCs” and under that they say:

10 “NG argues that the PRCs represent ‘payment completion’ which is ‘normal
11 competition’ and that the PRCs can therefore involve no abuse. In fact, Ofgem
12 demonstrates in the Decision by way of at least two counterfactuals that the PRCs
13 produce anti-competitive effects which are disproportionate and unjustified. In
14 particular, instead of the Legacy MSAs, NG could have set its prices (rentals) at
15 competitive levels in order to address its strategic objectives.”

16 That is 4.89 of the Decision.

17 “For the purposes of Ofgem’s alternative counterfactual, Ofgem assumes that NG
18 is permitted as a matter of ‘normal competition’ to have age-related PRCs in long-
19 term contracts.”

20 So that is the way in which, by the time you get to the defence, they are running their
21 argument.

22 My fifth observation is that I would ask the Tribunal to note the consequences of Ofgem
23 resorting to what it is now calling its “no PRC counterfactual”.

24 First of all, where are we procedurally? We have returned to the original case that Ofgem
25 was making in the first statement of objections back in May 2006. In that document
26 Ofgem’s case was fundamentally different from the one that you find in the Decision. It
27 argued then that National Grid could not lawfully have any kind of cancellation charges in
28 its agreements. Any such charges would, in and of themselves, be abusive. Can I show you
29 that. Would you pick up bundle PD1 and turn in it to tab 7. You will have there their first
30 shot, the Statement of Objections of 17th May 2006. If you go inside that to p.124 of the
31 numbering, you will see paras.4.55 and 4.56. I would ask you to look at their thinking at
32 this stage. 4.55:

33 “While reference should be made to Appendix 2 for a more complete description,
34 the Premature Replacement Charge underpins the glide path and involves the

1 recovery of the Net Present Value of the meters minus avoided costs ... This
2 enables National Grid to deter gas suppliers from removing and replacing legacy
3 meters in a shorter timescale than the contracted replacement period and restricts
4 the numbers of meters a gas supplier can contract with a competing meter operator
5 to replace.”

6 Then you get this:

7 “If a gas supplier wished a competing meter operator to replace more legacy
8 meters than permitted it would effectively pay twice for the meters: first to
9 National Grid in respect of the remaining value of the meters under the MSAs and
10 then to the competing meter operator for provision of replacement meters. It is,
11 therefore, not economically viable for gas suppliers to replace meters at a rate
12 faster than that prescribed by the MSAs.”

13 Pausing there and without going to it, our response to that was, this paying twice is not
14 paying for the same asset twice, this is the payment completion point. You complete
15 payment, you pay for the first one, and then, yes, you pay for the second one. So, yes, you
16 pay twice, but there is nothing wrong with that.

17 At 4.56 they said:

18 “In the Authority’s view, the glide path mechanism in respect of legacy meters as
19 described above would in and of itself amount to an abuse of dominance.”

20 Consistently with that, if you go to their directions which were at p.147 in that tab there is a
21 heading “THE AUTHORITY’S PROPOSED ACTION”, and you will see that the
22 directions they wanted then were, 7.4:

23 “The Authority is considering imposing directions with the following effect:

- 24 ● The MSAs shall be amended so that gas suppliers shall be entitled, on
25 reasonable notice, to terminate or to partially terminate ...”

26 – defined in the footnote as meaning you can choose the particular meters or type of meters
27 without restrictions, no exit charge –

28 “... the legacy and/or new and replacement contracts without penalty or charge in
29 relation to Meter Provision.”

30 Take out cancellation charges.

31 7.5 explains:

32 “The purpose of this direction would be to remedy the foreclosure effect in the
33 Meter Provision market by enabling gas suppliers to choose to move all or part of
34 their portfolio to a competitor to National Grid. It is considered that the installed

1 base of National Grid already gives it the advantage of some inertia on the part of
2 gas suppliers as regards the rate or level of meter replacement, such that any
3 restriction on termination is unnecessary. Faced with competing offerings,
4 National Grid may mitigate any potential stranding risk by meeting competition
5 ...”

6 Then that is defined, their vision at that time –

7 “... (through lower prices or innovative solutions) or – should it so wish – by
8 selling installed assets and so obviating the need for a new meter installation to
9 take place ...”

10 Although if you sell the assets, frankly, you are passing the rugby ball on to the person who
11 has bought them on those terms.

12 So what you see from that is that that was the case theory that we first faced in the first SO
13 about what was restrictive any PRCs. Our position is that Ofgem then subsequently accepts
14 in the case that cancellation charges in long term contracts are consistent with normal
15 competition in the market – I have shown you at least one of those many references – and
16 that National Grid is free to make such contracts as normal competition.

17 That change in position was the hallmark of the supplementary statement of objection. I
18 will not show you that for reasons of time. It is adopted in the Decision. We say it is
19 absolutely right on their part that to compete in that way with early replacement charges in
20 this industry is not a restriction of competition, it is a way of competing. In fact, having
21 said that, because now Ofgem come back with this no PRC counterfactual in the defence
22 and in its skeleton, it could be said, and we do say, that they are seeking to ride two horses
23 at once about what normal competition is, because in the defence and in the expert evidence
24 Ofgem continues to press the case that payment completion arrangements are normal
25 competition. I have shown you para.35 of the defence. Their expert says exactly the same
26 thing, that this is not compatible with normal competition.

27 If you turn from the procedural situation that has arisen, and which you will need to address,
28 what about the substance of the matter? I will foreshadow that. What are the consequences
29 of Ofgem’s supposed no PRC counterfactual anyway? Without the MSA agreements gas
30 suppliers would have continued to deal on the regulatory P&M terms, and National Grid –
31 and the evidence bears this out – would have continued to charge for the meters in place at
32 the price cap levels to minimise the losses to its business. As Ofgem said in that first SO,
33 as you saw, relying on this inertia.

1 The evidence that you will see shows that what that would have meant would have been
2 higher prices overall passed through to consumers, customer disruption and no gain in terms
3 of the introduction of the new technology. Put shortly, our case is that the MSAs, which
4 were a response to the problem, were in the interests of consumers. You arrive from that at
5 quite a novel and puzzling point, which is that Ofgem's case accusing National Grid of an
6 abuse by having made agreements which left consumers better off than they were before.
7 They are not aware of any case that has that feature. As for the idea of a restriction itself
8 under this no PRC counterfactual our submission is that what Ofgem's case boils down to
9 ultimately does not require any empirical evidence, any of this detailed, quantitative
10 assessment which took up so much of our time - and almost certainly yours as well in the
11 Decision - is an assertion which requires no evidence at all. It is the idea that the more
12 replacement activity you can get in the market, the more you can stimulate, even if it is
13 excessive by some economic lights, or artificial when you measure it against what we say is
14 a normal benchmark, then the more the customers are going to benefit because of what they
15 say are the products of dynamic competition. It is taken as an article of faith - more
16 replacement activity is less restrictive, is better for consumers regardless of any benchmark.
17 That trumps, as you will hear from Ofgem, all the empirical evidence in this case, showing
18 that these contracts were in the interests of customers and consumers.

19 I am conscious of the clock, and therefore I will say only this as my sixth point: there are a
20 lot of issues in this case, as you know. For the purposes of the remainder of my oral
21 opening, what we have done is to identify what we see - what we saw last night - as being
22 the absolutely key issues which you are going to have to deal with to resolve whether or not
23 to uphold our appeal. We had a go at summarising these on a single sheet of paper, which
24 you may find ironic, given the original length of the Notice of Appeal. However, there you
25 are. (Same handed): These should have been handed out to everybody here. (After a
26 pause): You will see that what we have done is to focus on the questions on the market
27 definition, dominance and abuse, and objective justification. Rather than in the longer way
28 of actually reading this out and asking you to take it down, I thought it more convenient for
29 you to see it in this form. It is probably unsurprising stuff to you, but I point out that in
30 relation to abuse, the way that we are approaching this is as set out there. The first question
31 we say that you will need to grapple with is what actually does this concept of foreclosure -
32 we say most properly anti-competitive foreclosure - involve in this case? What actually is
33 the benchmark against which you are going to need to assess the presence of anti-
34 competitive foreclosure by means of the MSA charges? (b) Is the use of a counterfactual

1 along the lines of the aged-based system used by Ofgem in the Decision an appropriate
2 basis of comparison, or not, when you are trying to show adverse effects on competition and
3 harm to consumers?

4 The last question, which relates to the nitty-gritty, is: If you find that it was an appropriate
5 path for them to have gone down, did they do it right? Has the analysis been correctly
6 executed? In short, that is our issue about revenue neutrality and its implications.

7 So, for the Tribunal's guidance, that is how we are going to be focussing what I am saying.
8 You will notice that it obviously does not include a number of issues that you also will have
9 to decide - for example, meter maintenance is not down on that list although we do contest
10 it strongly. That is because - as I have endeavoured to point out - Ofgem itself has not
11 treated that as the first order issue. These we see as the absolutely core points.

12 I am going to try to tackle those issues as well, time permitting. But, for the avoidance of
13 doubt, where I do not cover an issue orally that is not because it is unimportant. It is not
14 because we are abandoning it. We, of course, continue to rely on the written submissions.

15 Madam Chairman, with that, may I turn to the question of the essential factual context
16 because I would now like to ask the Tribunal to look at this in a little bit more detail? What
17 I am going to do is to cover seven factual topics which we say are essential for you to grasp
18 and to take account of in your deliberations. Just to give you a route map, first I want to
19 look at the nature of the complaint which triggered all of this, and, indeed, more generally,
20 the nature of the expressed industry concerns, such as they have been, about National Grid's
21 contracts..

22 Secondly, quite briefly, the relevance and importance of some costs as a feature of this
23 business.

24 Third, the question of the age profile of the installed meters - because there is a confusion
25 here which goes to the reasoning on both sides. I want the Tribunal to be aware of the
26 picture and the information which National Grid was working with when it concluded these
27 contracts with the gas suppliers.

28 The fourth point is about the issue of density because everybody agrees that it is good for
29 meter operators to be able to carry out their replacements in as small a geographic area as
30 possible. It makes it much cheaper. So, I want to look at the locations of these meters
31 across the country because one of Ofgem's findings in the Decision is that meters of a
32 similar age, perhaps like people of a similar age, tend to gather together.

33 The fifth point is the question of how closely the need to replace meters does correlate with
34 their age because Ofgem's essential case about the age-based approach is that you would

1 expect there to be quite a good correlation - the older ones are less valuable, and those are
2 the ones that you should incentivise the gas suppliers to take out first.

3 The sixth point is to make one or two observations about the system of price regulation
4 which Ofgem has applied and which continues to apply all the time, running in the
5 background.

6 The seventh point is what happens with the introduction of competition and what gas
7 suppliers said when they were offered these contracts.

8 I am going to deal with these as briskly as I can. May I ask the Tribunal then to go back to
9 the Decision first, and look at the complaint described in paras. 1.1 and 1.2 of the Decision.
10 Under the heading 'Introduction - The Complaint'. We see that all of this starts with the
11 complaint on 19th October, 2004 from a meter operator seeking to enter the market for the
12 provision of domestic-sized gas meters.

13 "The complainant expressed concern that the Legacy MSAs ... had the effect of
14 foreclosing the market to competing meter operators. Similar concerns were raised
15 by the same complainant and a number of other companies in response to the
16 Authority's Consultation into the National Grid's Proposed Restructuring of
17 Metering Arrangements in March 2005".

18 By the way, that is the consultation on the rebalancing I referred to a little while earlier.

19 "The complaint highlighted the following features that the complainant argued had
20 the cumulative effect of foreclosing the market:

- 21 * Excessively long contract duration coupled with the payments for
22 early termination:
- 23 * a condition precluding gas suppliers from replacing more than 5% of
24 a supplier's metering stock in any one year with contract penalties
25 for replacement above this level; and
- 26 * bundling of meter provision and maintenance."

27 Now, in fact, that is not an accurate description of this complaint at all, and I would ask the
28 Tribunal to pick it up in SD3, if you have bundle SD3 at tab.119. There you see the letter,
29 19th October 2004. It is a two page letter from the chief executive officer of that company,
30 and it is followed by a note towards the end beginning on 1656 actually, "Memorandum of
31 advice", I have to be careful that is indicated as confidential, from their corporate lawyers
32 dated 5th October 2004 at the end of the final page in that tab.

1 You will see if you go back to the first page of the letter what the complainant says in their
2 letter to Ofgem at the second paragraph: “Through issue of the Transco Metering Charges
3 Document” which is the Legacy MSA –

4 “...NGT has offered domestic suppliers two charging choices:

- 5 * The first option is the regulated rental charge per NGT’s published
6 ‘blue book’.

7 And for “blue book” you can read “the regulated contracts.”

- 8 * The second option is a reduced rate which can be secured by
9 continuing to employ NGT as preferred meter operator.”

10 Then if you turn over the page the way that the chief executive officer describes at the top is
11 they say:

12 “NGT’s introduction of these contracts provides Gas Suppliers with the option to
13 contract out of the regulated ‘blue book’ to the new legacy contracts which in
14 effect is a large inducement to maintain the status quo. This inducement is so
15 large that new entrants will almost certainly be unable to better it and hence gain
16 market share. Feedback from Gas Suppliers confirms our assumption. This
17 feedback can be made available to you.”

18 Pausing there, by “a large inducement” what we are talking about is they are offering these
19 new contracts at highly discounted prices, much lower prices and the complaint is that that
20 has – I am going to use the term now in a layman’s sense – a foreclosing effect. These
21 prices are so low that it makes it more difficult for us to get into the market.

22 In the next paragraph they say at the end:

23 “To support our views, we have consulted our Corporate Lawyers whose advice
24 would suggest that there may be clear breaches of the Act in several areas.”

25 Now, I would ask you to go to p.1658, which is part of the memo and, at the bottom of the
26 page has the three bullet points which were the complainant’s corporate lawyer’s
27 description of the problem, under the heading:

28 “The following practices of Transco may constitute a *prima facie* case of an
29 abuse:

- 30 * the excessively long duration of the agreements coupled with the
31 threat of imposition of payment for early termination will make it
32 difficult for other competitors to enter the relevant market.

1 * the provision of the financial inducements such as the significantly
2 reduced rental for the gas meters is a major incentive for suppliers to
3 remain with Transco.”

4 I pause there because that reflects what the chief executive officer said in the letter, and the
5 point that is drawn out is they are saying “yes”, these low prices are a problem for
6 competitors. They make it more difficult for us to get in and that has dropped out of
7 Ofgem’s account in 1.2 of the Decision. The third point:

8 “* the condition that precludes gas suppliers from replacing more than
9 5% of replacement gas meters from other sources ...”

10 Pausing there, that is actually inaccurate of course, because Ofgem have corrected it in the
11 Decision, it is not as though National Grid is bargaining to keep 95% of the stock in place
12 for the period of the contract. It can remove I think it is 5.5% to be accurate each year. The
13 point that I make is that you see from this the nature of the complainant’s concern is
14 actually about the foreclosing effect of the lower price, it is the emphasis, and moreover in
15 Ofgem’s description of this in the Decision it has become adapted, because that has dropped
16 out of their account in 1.2 of the Decision and instead what has come in is another bullet
17 point about bundling of maintenance. It is not in here, it is nowhere in here. It was not a
18 complaint and it has never been a complaint. That is the way that it is described.

19 Now, I would ask you to look at what other people said, other meter operators, after this
20 investigation was opened, so that Ofgem is now saying to the industry: “We are opening an
21 investigation for breach of the competition rules, into National Grid arrangements, and we
22 are sending out formal information requests to you and other people”, and it sends out these
23 requests called “section 26 notices” to, among other people, United Utilities Meter Fit, who
24 are here today and to Siemens – Capital Meter Siemens.

25 If you pick up PD4 and go in that to tab 114 and what you will find there is the response to
26 the information request directed to UU Meter Fit by United Utilities. That is dated October
27 2005, so the investigation has recently been opened, and I would ask you to look at 2655.
28 Ofgem asks a series of questions of the meter operator and on p.2655 at the top, (c) they ask
29 are there “any barriers to entry or expansion that you have not already covered in your
30 answer to this question?” Without boring you there was nothing relevant on the previous
31 pages. They say:

32 “Within a competitive metering market, a level playing field needs to persist in
33 order for cost reflective pricing to be competitive and the relevant market to
34 present opportunities.

1 In our opinion the introduction of the Transco legacy contract distorts this position by
2 introducing low pricing and consequently restricting market volumes.”

3 What I ask you to note there simply that the way in which they are approaching it again
4 similarly is: “These prices for the continued provision of the meters are low and that
5 restricts our opportunity as a new competitor.”

6 THE CHAIRMAN: Presumably the reason why they are low is that whereas under the regulated
7 contract the costs of installation and of the meter are part of the ongoing rental and are
8 recovered by the future payments of the rental over ----

9 MR. TURNER: Only if it stays in place.

10 THE CHAIRMAN: If it stays in place. Now you are going to ensure payment completion by
11 another mechanism, by the PRCs, and therefore naturally the rentals will come down
12 because you are not then going to include the PRC in the rental, or is that not right?

13 MR. TURNER: If I can try to assist, under the P&M contracts you are absolutely right, the idea is
14 that without competition, without the threat of somebody taking this meter out, the
15 Regulator has set the price cap at a level which means that absent competition everything
16 being equal you would expect to recoup a fair return on your investment, and no more than
17 that, that is the point of the strict price control applied by the Regulator. Now, National
18 Grid is faced with the problem that people can take out these meters at any stage and it is
19 going to be prevented from recovering that investment. Ofgem’s first idea in the first
20 statement of objections was that what it had done with these MSAs was actually to include
21 in them pricing arrangements which meant it continued to recover those costs, all of its past
22 investment, all of the outstanding past investment, in the regulatory value. No, that is not
23 what happened, madam, as you rightly perceive. They cannot do that because of the threat
24 that these meters can be ripped out an accelerated rate. They are forced. This is not out of
25 the goodness of their heart. It is competition. They are forced to offer the meters under the
26 commercial contracts at a discount.

27 The payment completion arrangements do not mean that by that different route they get
28 back the sunk costs, they do not. What they do is they get back a smaller amount equivalent
29 to the lower rental.

30 THE CHAIRMAN: Even under the legacy meters, if it goes according to your plan, say,
31 assuming that your plan is that people do not actually incur these charges ----

32 MR. TURNER: We are indifferent.

33 THE CHAIRMAN: -- that the installation costs will then still be recovered through the rental
34 payments.

1 MR. TURNER: This is a very important point, only in part, because if you take all of that sunk
2 costs as being reflected, which is an issue in the case, in the regulatory value, these early
3 replacement charges and the new contracts as a whole are not going to give you that money
4 back in full. National Grid has to sacrifice value. It does not matter to it whether people
5 take these meters out or not. The idea is to preserve as much value as they can get. If it
6 turns out to be a lot less than this sunk cost, including all the installation costs, it will not get
7 that back. In fact, you will have seen reference to the project name for this whole enterprise
8 being called “Project Jam” – “Project Jam” because what they were trying to do was
9 preserve, crystallise, the value of these assets. That is, therefore, that the contracts are not a
10 means by which, through a different route, they are recovering all these sunk costs, they
11 were recovering less.

12 We see there the way that UU says, “Hold on a second, we are being cut out of this market”,
13 that is its thinking.

14 What about my other friend over there, Siemens? If you go in the same bundle, PD4, to tab
15 97, you will find his client’s response to the s.26 notice, beginning on p.2490. They deal
16 with this issue, the most relevant bit is p.2496, where there is a question from Ofgem
17 recorded at the top:

18 “Do you consider that any of your customers have particular negotiating strength
19 in purchasing/renting gas meters?”

20 In the third paragraph they say this:

21 “Siemens is also concerned about events immediately following the last price
22 control.”

23 That was 2002.

24 “It had been our understanding that an objective of the price control was that
25 Transco would be making a case to demonstrate how their national monopoly and
26 co-ordinated activities would drive the lowest possible costs to their customers,
27 and that this was being done efficiently so that their prices could not be reduced.”

28 That is talking about the price control prices, those should be efficient.

29 “Nevertheless as soon as independent players submitted bids to enter the market,
30 Transco discounted their headline prices in response to competitive action from
31 new smaller market entrants.”

32 So again what they are saying is, “Hold on, we had imagined that these regulated prices
33 were the efficient cut to the bone prices, but as soon as people say, ‘We are threatening to
34 compete’, they discount them, this is a problem for us”. So again, the perception – you

1 need to bear in mind how the industry is looking at it – is that it is the low pricing which
2 has, in the lay sense, a foreclosing effect.

3 MR. VAJDA: Before that document is put away, I could ask the Tribunal to look at p.2500, the
4 last page, under the heading “Other relevant information”.

5 MR. TURNER: My friend is right to point that out, thank you. In 23, “Other relevant
6 information” they do point out there other relevant information that the restrictions, the
7 charges, on meters that can be removed in any given period affects the ability of other meter
8 providers to supply new meters and acts as a barrier to entry or expansion. I am grateful for
9 that correction.

10 At no stage that we are aware of, prior to these proceedings, has any industry party ever
11 complained about the absence of age related PRCs in this structure, as opposed to, for
12 example, what you have just seen from Siemens. The fact of exit charges is a problem, the
13 point that Ofgem then picked up in its first SO. At no stage does anyone complain about
14 age related PRCs or the structure of the charges in the MSAs as a foreclosing feature.

15 Again, I will be corrected on that if I am wrong. We believe that is the case.

16 It is not mentioned by Ofgem in the first SO. It is no part of the original case against us,
17 and it does not crop up again in the case which we are now confronted with in any form
18 until the supplementary SO which is April 2007 when Ofgem conceive it themselves.

19 That is my first topic which is the industry perception of the problem and how they
20 approached it.

21 The second area I will deal with very quickly, sunk costs. If you open the Decision at tab 1
22 of CB1 again, and you look at para.2.17, p.12 of the external numbering, there are two
23 propositions that come out of what Ofgem is saying here. The first is the recognition in the
24 first few sentences that the costs of these meters when they go on the wall are largely sunk.

25 They say half way down 2.17:

26 “The cost of the meter may not be a customer specific sunk cost as the meter
27 operator may be able to reuse the meter at another customer’s premises after it has
28 been removed.”

29 The qualification I want to enter there is that what is not pointed out, but which I believe
30 should be accepted, is that that is not the case for the vast majority of the credit meter stock,
31 the installed credit meters, on which this case focuses. As at December 2003 around 75 per
32 cent of all the installed base, for example, had the old imperial registers and they could not
33 be economically refurbished with metric registers. They could not be economically reused.

34 For your reference, that is in the agreed statement of facts, para.40.

1 What they then go on to say in the Decision is how competition takes place given the sunk
2 costs nature of the business, and in the last part of 2.17 Ofgem point out that meter
3 operators look to protect themselves against the risk of not being able to recover customer
4 specific sunk costs in a variety of ways. Then they mention too with which we agree: they
5 can charge an up-front installation cost for installing the meter; or they can offer suppliers
6 contracts that guarantee the recovery of any customer specific sunk cost through annual
7 rental charges over the life of the meter:

8 “These contracts levy a premature replacement charge set at a level designed to
9 recover any remaining customer specific sunk costs in the event of early
10 replacement of a meter that is not faulty.”

11 So two points. The first is that the two normal means of protection which are mentioned
12 here are up-front charging and the use of these exit charges. There is not a mention of what
13 is, I think, as a matter of common sense, the more hazardous course of saying, “We will
14 take our chances and charge higher rentals with no offer to customers from the outset,
15 higher rentals with no term commitment at all”, and none of the CMOs’ main contracts with
16 British Gas rely on that.

17 The other point, which is a point of factual clarification, is that although this refers to set at
18 a level designed to recover any customer specific sunk costs, picking up, madam, on your
19 observation about National Grid’s contracts, neither the CMO contracts, as far as we are
20 aware, or our contracts say, “This exit charge is set at a level to recover the sunk costs”.

21 They are set at a level to ensure payment completion - whatever that may be, whatever the
22 agreed payment is. Generally speaking, yes, that will be recouping the sunk costs.

23 The third point is the age profile of the meters. If you have the Decision open there ----

24 PROFESSOR STONEMAN: Just before you go on to that, could I ask you a technical question
25 about these sunk costs? You could say that in sense they are sunk costs because meters are
26 only rented and not sold. For example, would it be possible for National Grid either to rent
27 on to, or rent out to, a CMO a block of meters in an area -- or, for example, a CMO taking
28 over the supply of meters to a particular gas supplier from National Grid to buy the old
29 stock of meters from National Grid?

30 MR. TURNER: Yes.

31 PROFESSOR STONEMAN: Because, if that is the case the sunk cost is not zero because these
32 meters will have a value on the market. They only have a sunk cost of zero if they are
33 restricted to have to be owned by National Grid.

34 MR. TURNER: I fully see the point.

1 PROFESSOR STONEMAN: Is it possible to have these alternative arrangements? That is the
2 question?

3 MR. TURNER: If I can approach that on a practical level, the answer is, as you have seen, that
4 originally Ofgem were saying, "Look, one of your ways of dealing with this problem, in the
5 proposed remedy in the first SOs, you could have sold these installed assets. You would
6 have got some money then". National Grid's response is, "Well, that's all very well to say.
7 We were not ruling out sale". That is a fallacy which you find in the Decision because
8 National Grid never ruled out sale. The problem is that you have then got to find someone
9 who is willing to buy these things on the basis that they have not got any term protection
10 with the gas supplier - hence, my reference to passing the rugby ball on. So, National Grid
11 needs to find, if it is going to sell it, a buyer who is prepared to reflect in the price they pay
12 for buying the meters the fact that there is no term protection. In a sense, had they been
13 able to find someone, that would have been wonderful. But, in our view, it means,
14 logically, moving that problem further down the line. They did not find anyone who was
15 prepared to pay a reasonable price for these meters.

16 PROFESSOR STONEMAN: Did they try?

17 MR. TURNER: (After a pause): We will check. I believe for the moment you can work on the
18 basis that we did not try actively to market the meters, no. Work on that assumption unless
19 I correct it.

20 So, then we come to the age profile of the meters. If you go to para. 2.24 in the Decision
21 you will see the topic which is addressed there. Now Ofgem is looking at the ages of the
22 installed meter stock we are concerned about. On p.15 you have that graph showing the
23 very uneven profile of the stock in terms of ages. It is credit meters. You see the numbers
24 on the left and the ages on the X-axis.

25 I want to point out that this is not actually based on the actual ages of the Legacy meter.
26 There is no qualification here as to which is their year of manufacture. The year of
27 manufacture information is what National Grid had available and used for its own business
28 purposes throughout the MSA negotiations. What you have got here is year of installation
29 information. Now, staying on the year of manufacture, National Grid - and this will help
30 you understand the documents when you see them - did not have available to it any readily
31 usable information about the ages of its meter stock. That is why you are going to see
32 references in the contemporaneous documents, including the purely internal ones for
33 National Grid, to there being a large number of Legacy meters throughout the land of

1 unknown age. This figure does not refer to meters of unknown age. It is necessary to
2 understand that ----

3 THE CHAIRMAN: Just say that again? The age years of this Figure 1 on p.15 ----

4 MR. TURNER: That is when they were installed. Some meters, apart from any gap between
5 manufacture and installation, are refurbished and reinstalled. Now, it is necessary to
6 understand this difference in the context of the claim which is made by Ofgem in the
7 Decision prominently. There is an age-based system of PRCs for this installed base of 17.5
8 million meters which end up being covered by the Legacy arrangements credit meters. It
9 would not only have been normal and natural - which is what they say - but perfectly
10 feasible, by which I mean that it would have been easy for them to arrange. You will see in
11 the Decision at various points that they say that, "At one stage in the negotiation you were
12 thinking of arranging PRCs on the basis of a Glass' Guide where you tie up to each meter,
13 according to its age, a particular value". One of the points between us and Ofgem is that we
14 dispute that quite vigorously and say, "Actually, no. The information we had available at
15 the time on meter age was not perfect". This new information here - and I will clarify the
16 point now - which relates to the year of installation as proxy for age was assembled by
17 National Grid in the course of this investigation, and especially for this investigation when
18 we were responding to the supplementary statement of objections in the summer of 2007.
19 As I mentioned, that is the time when Ofgem first came out with the allegations based on
20 the objectionable absence of an age-based structure of charges. What I want to emphasise
21 is that producing that information at that stage was based on a huge amount of internal work
22 which involved drawing together and analysing hundreds - many hundreds - of different
23 data sets.

24 You will see, I hope, that this is an important distinction. To see the information on meter
25 age which National Grid actually had available prior to that large exercise please pick up
26 PD1 which contains National Grid's own s.26 response to Ofgem's question about the age
27 profile of its meters. That is at Tab 12, at the end. This is now National Grid in December
28 2006 providing information to Ofgem. It is an update of information which has previously
29 been provided in 2005. Now, if you go to p.805 and to Response 6(e), and to a question
30 asking about the age of the meters -- Look at that table there. What you will see is a large
31 list of the ages of the meters going, actually, all the way from zero to to 45 years in some
32 cases, then older than 45 or unknown, you get this large amount of 709,750 meters
33 mentioned, you see that. Now, what you see from this, if you draw a line across at the 20

1 year point on that table, for a start is the very large numbers of meters still batting on and
2 functioning after that 20 year cut off point.

3 THE CHAIRMAN: Are rentals still payable on those?

4 MR. TURNER: Oh yes ,these are fully functioning meters which both under the price control
5 arrangements, and under the new arrangements are perfectly good. Rentals are still payable
6 because they are perfectly good meters doing their job from year to year. What you see
7 though is that there is this very long tail in fact of older meters there and that is after the 20
8 year point which Ofgem, in its age related counterfactual has taken as a cut off after which
9 it was going to treat meters as entirely free to replace, a sort of rule of thumb end of useful
10 life.

11 As I say, there was an earlier table from which this is updated relating to the figures in
12 December 2005. This is a snapshot referring to October 2006. Without boring you by
13 going back to the earlier table, because of the progressive way in which meters come out
14 and new ones come in the figures were different and so the earlier table had shown, for
15 example, a higher number of very old or unknown meters, that had been about 750,000 as
16 opposed to the 710,000 you see here.

17 You see from footnote 4 that National Grid told Ofgem that all meters with an installation
18 date – that should have said “manufacture date” by the way – of 1960 or earlier are shown
19 in a single row in the table above. Certain years, “notably 1900 and also 1960 are known to
20 have been entered historically as default year of manufacture”. These meters would have
21 been installed before 1995 when regional information was transferred to Transco’s E&MW
22 databases, so that is at least nine years old from the beginning of the Legacy MSAs, but
23 likely to be after 1980 when synthetic diaphragm meters were introduced. This explains the
24 high number of meters shown in the final age category in the table above. So there what
25 you see in other words is this very large group which were dumped into that category as
26 being age unknown. Now, after National Grid filed its written representations on the
27 supplementary statement of objections, if you go back to April 2008.

28 MR. SUMMERS: Forgive me, Mr. Turner, I am sorry to interrupt you again. You did correct a
29 word there, you said instead of “installation” it should have said “manufacture”. Does that
30 actually also apply to the table to which you were directing us in CB1 at p.15, which was
31 the bar chart?

32 MR. TURNER: No. What Ofgem has done is it has taken the installation date. In that table it
33 does not show in the unknowns or anything like that, it just gives these definitive ages.

34 MR. SUMMER: It is agreed, is it, that in PD1 that is dates of manufacture?

1 MR. TURNER: Absolutely, yes, it is. Let me explain a bit further because it is quite an
2 important hidden point of confusion. What happens is that National Grid, when we know
3 there is a case against us based on ‘you should have used age-based charges’ then engages
4 in the summer of 2007 in all this work, putting together what data sets it has on the
5 installation. From that it constructs something entirely new which it did not have before,
6 which then feeds into the Decision.
7 Ofgem, however, were upset by that and wrote to National Grid accusing National Grid of
8 having apparently failed previously to give it required information in its possession about
9 meter age. If you pick up PD3 and go to tab 34, without running through this, there is a
10 letter from Ofgem dated 13th July, we now see in you representations on the supplementary
11 statement of objection something entirely new, which is all this information about the year
12 of installation of these meters. We think that you have apparently failed to have complied
13 with previous requests asking you to give the age of the meters. National Grid’s response
14 is at tab 37 from the General Counsel and Company Secretary for the UK, Alison Kay. It is
15 a letter of 18th July 2007. This is a very detailed letter but in it National Grid explains in
16 detail the age information which it actually kept and how this had been used in National
17 Grid’s responses to Ofgem. Very briefly at the bottom of the first page you will see under
18 the heading: “Information provided in respect of the ‘unknown’ meters” that we provided
19 what we had on the age, which we took to be year of manufacture and the last sentence was
20 that:

21 “.. our Asset and Data team looked at the year of installation data that was held on
22 our database but concluded at that time that this was not sufficiently accurate to
23 use as a check on the meter age information.”

24 Over the page under the heading: “The suggestion that relevant information was withheld”,
25 Miss Kay wrote:

26 “Firstly, it might be helpful if I explain how the information in the second written
27 representations came to be developed. IN the second SO the age of the meters had
28 now become an important issue, because it as directly relevant to the question of
29 the impact of using age-based PRCs ... In preparing the written representations,
30 the member of the response team who had looked at the year of installation data
31 information in December (for the purpose of preparing the response to [the earlier
32 notice] considered again whether there was a different source of data that could
33 be used which would confirm the position already indicated to the Authority. He
34 also identified with the Asset and Data team, that a data ‘dump’ had taken place in

1 December 2003. This data needed to be reconstructed by combining a large
2 number of different data files as described in our written representations and
3 provided information on meter year of installation as well as year of
4 manufacture.”

5 When they did that they found a better correlation than they had seen before to the age of
6 the meter than had been derived earlier and they used that.

7 If you turn to table 8 in this letter, p.1714, this is perhaps just another way of presenting the
8 age data which we actually had and which we used for the original response. You will see
9 that is entitled: “Age profile of gas meters ...” that is the domestic sized ones “... rented
10 under the legacy MSAs at end December 2005 consistent with the [notice]”. Now what we
11 are doing is saying this is the information we were looking at on our year of manufacture. It
12 goes all the way back to before the First World War where, according to the information on
13 the file, there were 742,000 gas meters listed as having been made in the year 1900.

14 THE CHAIRMAN: Very few of those presumably were actually made in 1900.

15 MR. TURNER: That is the point. What was happening was as we pointed out in the footnotes –
16 if you go to footnote 2 here you will see again on p.1716, that for certain years, “...notably
17 1900 but also 1960 they were known to have been entered historically as a default year of
18 manufacture.” We basically had been working on the basis we do not know the ages of lots
19 of these meters. It also shows the lumpy age distribution of this meter stock. You will see,
20 for example, these peaks in 1991 to 1993, you see it rising to a peak of meters recorded as
21 having an age dating back to then, and again in 2001 you see a peak there and it falling off
22 in 2002 very sharply.

23 THE CHAIRMAN: What was it that caused that peak between 1989 and 1993, do we know?

24 MR. TURNER: I will check over the short adjournment, madam.

25 MR. SUMMERS: You did mention an transition from Imperial to Metric, I do not know whether
26 that ----

27 MR. TURNER: Yes, now I believe that was later, I think it was from the year 2000 that you had
28 by law to install only metric meters.

29 THE CHAIRMAN: Was it the synthetic or leather diaphragms, maybe.

30 MR. TURNER: I will check but that could well be part of the explanation because we do know
31 that beginning – I will have to check the exact period, I think in the 80s, with the switch to
32 natural gas the old leather diaphragms need to be replaced progressively by new synthetic
33 diaphragms for the meters to be accurate. Actually that may well be part of the explanation
34 for why you see this pick up.

1 The key point I wanted to show you is that is the age information that people have been
2 working on at the time, and the very lumpy age distribution and also the huge long tail of
3 fully functioning meters working very well from year to year which go back a long period
4 in time.

5 Madam, if that is a convenient moment.

6 THE CHAIRMAN: Yes, thank you, Mr. Turner, we will resume at 2 o'clock.

7
8 (Adjourned for a short time)
9

10 MR.. TURNER: Madam, before beginning this afternoon, may I just check with the Tribunal
11 what its position is on timing?

12 THE CHAIRMAN: We were about to check with you what your position was on timing.

13 MR. TURNER: My position is that, having attempted just now to scale down quite significantly
14 on this factual side, I still do want to spend a bit of time taking you through the remaining
15 points that I have mentioned, but appropriately confined. I will then hope to get on to
16 market definition and dominance. My original plan was to try to get that done by the end of
17 today. I have not got very many points to make about it, and I hope that I can take that
18 quite quickly. My plan would be for us to finish that by the time that you rise today. My
19 concern is that if we get to four o'clock sharp and you need to leave, I will not have been
20 able to do that.

21 THE CHAIRMAN: I think we were planning to sit until 4.30 today. If we need to start at ten
22 tomorrow morning in order for you to be sure to have finished before the short adjournment
23 then I think we can, but I do not want Miss Carss-Frisk to be cut short, or only to have a
24 short time to get under way tomorrow afternoon. She really does need, I think, to start
25 straight after lunch.

26 MR. TURNER: Yes, I appreciate that.

27 Madam, a few points of factual clarification were inevitably drawn to my attention by my
28 client over the short adjournment, and I will take these quite quickly. The first is just to
29 remind the Tribunal that these NR contracts are separate contracts. They operate separately.
30 Without taking you to it, there is a passage in the Decision, for the record, paras.2.83 and
31 2.84, which seeks to suggest that in practice at least one gas supplier, or perhaps more, may
32 have assumed that these were required to be signed together. Our case is that that is, in fact,
33 wrong and misleading, and the references to what we said about that, if that is an issue, are

1 in our written representations on the first SO, PD1, tab 8, 229, paras.2.10 to 2.24. I say no
2 more about that.

3 The second point that I was asked to make clear is that one other feature of these contracts
4 is that if a gas supplier, such as British Gas, loses retail business to another gas supplier,
5 PRCs are not triggered because of that. What happens is that under the contracts the
6 minimum scheduled number is adjusted to reflect the change in your portfolio, so that you
7 are from that point on ----

8 THE CHAIRMAN: Now you have moved to the Legacy MSAs?

9 MR. TURNER: Sorry, I am now talking about the Legacy MSAs, and saying there that there is a
10 mechanism which means that if a retail gas supplier loses business the obligation to rent is
11 adjusted to reflect the change in the size of the portfolio.

12 THE CHAIRMAN: Does that meter then go into the legacy contract with the other gas supplier,
13 or does it go into its NR contract?

14 MR. TURNER: If the other gas supplier is one of the people who signed the MSAs, because EDF
15 did not, my understanding is that it then becomes subject to the MSA agreement signed by
16 that gas supplier, the second gas supplier, as a legacy.

17 THE CHAIRMAN: As a legacy?

18 MR. TURNER: Yes, that is right.

19 The third point relates to that table we were looking at with the ages of the meters, and,
20 madam, it turns out that your supposition is right. We will see in a moment this leather
21 diaphragm replacement programme kicked off in the early 80s and was progressively
22 undertaken. So you saw during that period up until, I think, the late 90s, quite a number of
23 meters needing to be replaced so that the diaphragms were of the new kind and the meters
24 were accurate.

25 I am also told by Mr. Way, who is the relevant man at National Grid and has been with the
26 company for some 30 years, that around that time there was an infill programme in which
27 the local gas suppliers were extending the gas network, and that accounted for meters being
28 fitted around that time as well.

29 I have dealt with the ages of the meters. The next topics was their locations and whether
30 meters of similar ages are generally clumped together geographically or not. If so, that
31 could make it efficient for gas suppliers and their CMOs to target the replacement of older
32 meters and achieve this desired density of operations. If you open and turn to 2.25 on p.14
33 of the external numbering, the penultimate sentence reads:

1 “If suppliers targeted replacement of meters over a certain age it is likely that they
2 would achieve density, as a significant proportion of the gas meters in a particular
3 area were installed around the same time. The introduction of natural gas in Great
4 Britain required the conversion from town gas and installation of new gas meters,
5 which was carried out progressively by area boards.”

6 There is a reference there to an illustrated history of the gas trade as the source for that.

7 That was then picked up by Ofgem in its reasoning in the later analytical sections. If you go
8 to p.110 ----

9 THE CHAIRMAN: Does that mean that there is no legacy meter which pre-dates the introduction
10 of natural gas?

11 MR. TURNER: Not at all. As you have seen, in some cases these meters have been in situ for a
12 very long period indeed. They should be subject to a replacement programme. There are
13 difficulties sometimes with replacing meters. As you have mentioned it, madam, one part
14 of the statement of facts that I have gone to is that, as well as density, another feature of this
15 market is access. Very often you turn up at somebody’s house, they do not let you in, there
16 are problems of access to some of these meters, and that accounts for the fact that even
17 where they are meant to be replaced they are not. The evidence in the agreed statement of
18 facts suggests that this is particularly the problem with some of the oldest meters.

19 I was going to para.4.173 on p.110 just to show you how that follows through to Ofgem’s
20 reasoning in the Decision. In the first sentence Ofgem is responding to National Grid
21 drawing attention to what it saw as problems with an age based approach, and they said:

22 “Furthermore, even if under an age-related approach gas suppliers were to require
23 CMOs to target meters over a certain age only, it is unlikely that this would
24 impeded the CMOs in achieving density.”

25 Then there is this reference to, if you read through, the likelihood that a significant
26 proportion of meters in a particular location will have been installed at around the same
27 time and will be of a similar age, and so on. The source for that, as you saw a little while
28 ago from the footnote in the Decision under 2.25, was an illustrated history of the Gas Trade
29 Association. For your note it is this. We can hand that up as exhibit A at the end of today.
30 The relevant extract is, for your note, SD6 at p.187, and what you will see there is a fairly
31 bland statement that, progressively, the gas boards have to replace the existing meters.
32 If Ofgem had investigated the matter with National Grid or with any other parties before
33 reaching that finding in the Decision, it would have learned that that was wrong. If you turn

1 now to the statement of facts in CB2, tab 20, and go to paras.25 to 31, you have there what
2 we say is the correct position. All of this is in black text, which means that Ofgem is not
3 prepared to agree it, but the essential points are in para.28, where we say that, based on the
4 data available to National Grid, there are very few areas of the country where one finds high
5 densities of old meters.

6 Then para.31:

7 “... in some regions of the country, the scarcity of old Meters is particularly acute.
8 The two British Gas areas that were allocated to one of its CMOs, Meter Fit, were
9 characterised by this age profile. National Grid data shows that the numbers of old
10 Meters in those areas is lower than the national average.”

11 Essentially it is saying that the numbers that were contracted for by Meter Fit with its
12 contract with British Gas were significantly above the numbers that would have reached
13 twenty years of age at the end of 2006, by the end of the first three years of the Legacy
14 MSAs. What you will see from the evidence, which we will come to when Mr. James
15 comes into the witness box, is that in practice British Gas started off by saying to its meter
16 operators, “You must only replace meters above twenty years of age”. It had to drop that -
17 there were not enough - first to eighteen years, then to fifteen years, and then, in the case of
18 Meter Fit, all the way down to twelve years. Even then, Meter Fit was grumbling that there
19 was not enough. Our position is that that gives you an indication of the difficulties with a
20 purely age-based system of replacement (which I will be coming to in submission).

21 The fifth topic - the correlation between replacement of meters and the need to do that, and
22 how old they are. Ofgem’s counterfactual in the Decision works on the basis that older
23 meters should be cheap to replace, and so that gas suppliers should have the incentive to
24 target the oldest meters first for replacement. They make that explicit in its defence. If you
25 look in CB1 at the defence, in numerous places, for example at Tab 3, p.587, para. 284, you
26 will see in the final sentence,

27 “Had suppliers been paying age-related PRCs, they would obviously not have
28 replaced the meters which they did in fact replace: they would have targeted older
29 meters”.

30 So, that is what they say would have been the incentive. The associated factual point though
31 is that British Gas did try, in fact, to replace the oldest meters and was progressively driven
32 back from that. They say that at various other points. For example, just for your note, para.
33 293(d) makes the same point.

1 So, the question arises: Does taking out the old meters first match the natural replacement
2 pattern for meters? Ofgem did actually investigate the extent to which the meters that tend
3 to become inaccurate and to need taking out are the oldest ones. It did not record those
4 findings in the Decision. There is something on that, however, in the supplemental
5 statement of objections. If you pick up PD2, Tab 31, you will see at para. 2.110 Ofgem
6 recorded,

7 “In each year of the Legacy MSAs to date, National Grid has identified substantial
8 numbers of relatively young DCMs as requiring replacement because batches of
9 meters have been found to be inaccurate or unsafe”.

10 Then they give the ‘for examples’ and you will see that in 2006 the figure was 17 percent
11 credit meters and 21 percent of PPMs. They go on to say,

12 “The fact that these relatively young meters have been identified by National Grid
13 as not fit for purpose, and requiring replacement, has no bearing on the extent to
14 which early replacement charges might become payable”.

15 Now, I need to enter one qualification, which is that, for the avoidance on our side, although
16 they say ‘unsafe’ there -- National Grid wants it to be known that these meters were not
17 ‘unsafe’ -- The question was one of accuracy and good estate management - meters that
18 needed to be replaced for those sorts of reasons and not because they were liable to blow up
19 or anything of that kind. But, the essential point for these proceedings is that in quite a lot
20 of cases meters which need to be replaced are younger ones, not older ones.

21 Another highly relevant point of a similar kind, again not in the Decision, but
22 which had been raised in the investigation is this: Since 1997 first the MMC and
23 then Ofgem -- Ofgas had both been setting their faces against allowing National
24 Grid a capital expenditure allowance in the price controls which was based on the
25 policy of replacing Legacy meters based on age after twenty years in situ
26 specifically. If you go to Tab 33 in PD2, the essential point is at paras. 51 and 52.
27 “It should in any case be noted that the Authority’s price controls in 1997 and 2002
28 have been based on efficient levels of meter exchanges occurring, which are
29 determined by condition or performance criteria, and not by age. All other things
30 being equal, an old meter will not merit efficient replacement if it is continuing to
31 function well. In its approach to price control regulation, the Authority has
32 therefore always limited the capital expenditure that it is prepared to allow for
33 efficient meter replacement by Transco/National Grid. Thus, for example, in the
34 2001 Draft Proposals the Authority stated ----“

1 They cut National Grid back on its proposals. At para. 52,

2 “It is also worth noting that, at the time of the 1997 MMC Report, British Gas
3 [which was then National Grid] wanted to continue with a twenty year meter
4 replacement policy. Both Ofgas and the MMC declined to follow such an approach
5 which was incompatible with efficient capital expenditure in the interests of
6 consumers”.

7 The point was that many old meters, beyond twenty years, continue to function perfectly
8 well and do not need taking out on account of them becoming inaccurate or, to use the
9 emotive term, unsafe. Mark Way, who was the source of my information over the short
10 adjournment, is National Grid’s asset and planning manager. You will see that in his
11 witness statement (when we come to it) he gives specific evidence about this. In particular,
12 what he explains is that within the 20 million or so Legacy meters you get a range of
13 different types and vintages, and they are not, by any means, all the same. Some of them are
14 workhorses which can bat on without a problem for years and years. Some, such as these
15 black, square meters, needed to be replaced after less than six years.

16 That is the correlation between age and replacement.

17 Sixth, the system of price regulation.

18 THE CHAIRMAN: The black, square ones - did something happened to them in situ which has
19 made them go wrong, or was there some kind of design glitch which meant that they were
20 destined to go wrong.

21 MR. TURNER: I am going to be corrected on this in due course, but essentially what National
22 Grid does generally is to sample its meters regularly to comply with its obligations to ensure
23 under statute that they remain in good working order. If more than a certain percentage -
24 and this was the system that operated until recently (April 2008) - of the sample turned out
25 to be outside agreed tolerance for accuracy ranges, then they said, “Right, this stock -- this
26 vintage have all got to be replaced”. They were then all put on a schedule - this big
27 replacement schedule. They needed to be replaced in due course as soon as that could be
28 efficiently programmed. I believe that the black square meters will have been scheduled
29 for replacement based on that sort of approach. (After a pause): Mr. Way nods. So, yes,
30 that is what happened in that case as well.

31 Turning then to the sixth point - the system of price regulation for meters. That is addressed
32 in Ofgem’s Decision at paras. 2.44 to 2.60 on pp.21 to 25 of CB1. There is an account
33 given by Ofgem there in the factual section which runs all the way from 2.44, p.21 of the
34 external numbering, down to 2.60 on p.25. This is an important part of the factual context,

1 the four propositions on which National Grid relies in its appeal. Number one, the history
2 of price regulation for these meters is such that you cannot identify the unrecovered or the
3 sunk costs of providing an individual meter, or even any meter made in a given year. That,
4 in a sense, sets the legacy stock which National Grid has at the time of the introduction of
5 competition apart the case of new and replacement meters yet to be installed in the new
6 competitive market, and that is because before you fit new and replacement meters under
7 these contracts giving the long term protection, as the CMOs and National Grid have all
8 done the operator can include in the contract a system of these forward looking early
9 replacement charges, those are the commercial arrangements they have made. It is reflected
10 in the statement of facts, paras. 50 to 51 which I do not ask you to go to now.

11 But for the legacy meters it is all tangled up because of the historic system of charging.
12 You will remember, for example, that before 2000 transportation is muddled up with
13 metering and ----

14 THE CHAIRMAN: Wait a minute, I thought you said you cannot identify the sunk costs, but
15 now you are saying you cannot identify how much is unrecovered of the sunk costs?

16 MR. TURNER: Well, you cannot identify the sunk costs or the portion of it which remains
17 unrecovered either. You are unable to know that, the information is not kept for any
18 business purposes and you do not know it.

19 The second point for the system of price regulation is the observation I made earlier that
20 National Grid is constrained to charge for the PPMs at a level which is a lot below this
21 commercial cost and in practice the effect of that is to make them much cheaper than the
22 PPMs, which commercial competitors can and do offer. In the Decision, if you have that in
23 front of you at para. 2.117 Ofgem records the fact, which is right, that National Grid's
24 annual charges for the PPMs have been much cheaper, and you see the figures there
25 compared with, it looks like a confidential level of charge for the commercial operators.
26 The reason, however, is omitted, that by contrast with the supplemental statement of
27 objections, and I will not take you to it but I will give you a reference, it is 4.67 where
28 Ofgem had pointed out that the reason was its price cap.

29 We say that is important because if you are examining the incentives that gas suppliers do
30 and do not have you take that into account as a relevant fact.

31 The third point is that Ofgem's system of regulation has at all times as you know required
32 National Grid to offer the gas suppliers the contracts on the P&M terms, no notice contracts
33 and price capped. Our case is that the relevance of that is very considerable indeed.

34 National Grid did not impose or foist these MSA agreements on the gas suppliers, they were

1 not “must deal” terms. The gas suppliers had the option of staying on the P&Ms and in our
2 case that neutralised, drew the sting from the ability to extract disadvantageous terms, that is
3 part of our case on dominance, market power.

4 The fourth point is that the system of price regulation which Ofgem used depends on
5 identifying what is called “the regulatory value” for the meter assets. Whatever the precise
6 derivation of that you will see reference in the Decision to “a focused or unfocused
7 approach”, and no doubt that can be explored with the experts. This regulatory value is the
8 definitive statement for regulatory purposes of the unrecovered costs of National Grid’s
9 legacy meters. It is the amount on which they are then entitled to make the return subject to
10 the price control. In fact, National Grid made detailed submissions during the
11 administrative procedure that the RAV (regulatory asset value) in this case is a good
12 measure of the overall sunk costs of the meter assets. The relevance of us having done that
13 is twofold. First, it goes to the topic of market power and dominance, because National
14 Grid did not have enough negotiating power in the negotiations to recover its sunk costs for
15 which we say the regulatory value is a good benchmark. Secondly, it goes to the topic of
16 objective justification because Ofgem says in its decision that it would have been
17 proportionate had National Grid put in place a system of charges to recover its customer
18 specific sunk costs. National Grid says that the only sensible way in which anyone could
19 approach that for the installed legacy base is at the overall level. On that basis because the
20 RAV is a good measure of sunk costs we say that National Grid has acted justifiably.
21 There is then an issue of fact between the parties, or if you like expert opinion, about
22 whether this RAV does represent a good measure of our sunk costs. I say again that this is a
23 point that National Grid argued and developed with evidence in the administrative
24 procedure. It was at no point contested by Ofgem. Finally, when National Grid repeats the
25 point in its notice of appeal Ofgem then files evidence, two overlapping pieces of evidence
26 from two witnesses to contest it for the first time, albeit on the level of principle only. I
27 need to say that National Grid is very happy to have the debate in court and for you to hear
28 the experts and we will do that if you require it. But we say it is actually wrong as a matter
29 of the Tribunal’s procedure because our point about the relationship between the RAV and
30 sunk costs is something that reflects faithfully our prior submissions in the administrative
31 procedure and our evidence to Ofgem, and because it was not picked up by Ofgem in the
32 Decision the matter ought to be regarded as closed.

33 I am just going to give you the references in the interests of time to our written
34 representations and I would invite you after this hearing perhaps just to turn those up

1 because they are detailed. First, our written representations on the first SO at para.149, that
2 is PD1, tab 8, p.216. Then in the supplemental SO representations PD2, tab 33 p.1306,
3 beginning there at paras. 123 to 127. You will see from that, that this was covered by
4 National Grid, it is relevant, it has been treated as relevant for the same reasons as it is now
5 offered in the appeal and it was not contested until the defence.

6 Finally then, I turn to the last topic, the introduction of competition, the more interesting
7 part because we are back on the story. I would ask the Tribunal to pick up CB2 and go
8 again to the statement of facts, at paras. 53 to 57 of tab. 20 – a lot of that is in green, so you
9 can take it as agreed between the parties. That describes the process we have already
10 referred to briefly about the introduction of the P&M contracts and their genesis, our point
11 being that they contain no what we say are normal arrangements for payment to be
12 completed in the event of early replacement of the meters.

13 There is also this: the prices of the rentals under the price cap, if you think about it, cannot
14 be increased above the price cap level to reflect the risk of early replacement, and Ofgem
15 accepts in the Decision – and I will simply give you the reference – that the price cap was
16 not intended to, and did not, compensate, it says “fully”, for that risk. That is 2.49 in the
17 Decision.

18 THE CHAIRMAN: I am sorry, could you just make that point again?

19 MR. TURNER: Yes, the price control sets a price cap. The price cap is not lifted, so you cannot
20 price above that, to take account of the risk that in the new world of competition people can
21 take out your meters early, you will not recover your costs or anything like that. That is the
22 first point.

23 THE CHAIRMAN: You say the price cap cannot be lifted ----

24 MR. TURNER: You cannot go above it.

25 THE CHAIRMAN: -- but does the price set in the cap incorporate any element to reflect the risk
26 that customer will change to a CMO?

27 MR. TURNER: For that we need to go to the Decision at 2.49. This is a long paragraph, but
28 briefly in it Ofgem says that in setting the price cap they made some adjustments to the
29 basis on which previous regulated meter prices have been set to take account of the
30 introduction of competition. They then explain that they did two things, one of which was
31 to use a slightly higher cost of capital than the one used for the regulated monopoly
32 transportation business, reflecting, they say, the increased commercial risks that National
33 Grid might face. The second was to adjust the depreciation allowances when they were
34 setting the price cap. You will notice, however, that for the installed meters, the average

1 remaining asset life is at ten years, which equates, of course, to an estimated life of 20
2 years. The point they make at the end of this paragraph is:

3 “The effect of both of these decisions was to increase the maximum prices that NG
4 could charge for its meters above the level that they would otherwise have been,
5 although this was not intended to compensate National Grid fully for any potential
6 stranding ...”

7 That means the removal of the asset early –

8 “... as is explained in more detail below.”

9 So what was it all about? There were certain adjustments made. We say it was about the
10 forward looking risks of competition in a new competitive market that would be faced, it
11 was not about the risk of stranding of past assets. I will give you the reference in which we
12 debated this with Ofgem. It is our written representations on the SSO, PD2, tab 33, 1213,
13 paras.17-19.

14 I am sorry for having taken it in a slightly condensed way. The only reason I did that was
15 because at the end of that long paragraph Ofgem themselves reached the conclusion, or say,
16 that it was not intended – their word “fully” – to compensate National Grid for the asset
17 stranding risk.

18 So on everybody’s understanding, Ofgem’s and ours, one way or another there is something
19 sticking out of the duvet there that has not been covered in the price control, which is the
20 risks of the asset stranding.

21 THE CHAIRMAN: The point that interests me more is what that says about what you would
22 expect to happen to rental prices when you introduce the PRC, because you are then
23 stripping out that risk of stranding, in effect. In so far as an element has been included in
24 the P&M rental price to reflect the fact that there might be a default you expect the rental
25 price to come down a bit once that risk has been removed by the introduction of the PRCs.
26 What you are saying is that whatever increase there was in the price capped rental it was not
27 a huge amount.

28 MR. TURNER: It was not a huge amount. We say it was not intended to reflect this asset
29 stranding issue at all, and I have given you a reference for that. Ofgem do not quite put it
30 that way. What they do say is that this adjustment to the price control, as you have seen in
31 the Decision, did not compensate fully for that risk. Our written representations pointed out
32 that the effect of the adjustment to the price control was extremely small. What you will see
33 in the course of the story is that National Grid continues to be concerned that this has not

1 been dealt with in the price control and is at first asking Ofgem to take it into account by
2 introducing a change to the network code provisions.

3 When that does not arise, or that is not a possibility, the attention switches to these new
4 commercial contracts. Just to give you a reference as we are on it, if you pick up WS2, and
5 turn to tab 19, you will see a letter there. This is now September 2002, National Grid
6 discussing with Ofgem the issue of premature replacement charges. You will see that. The
7 letter is from Miss Frerk at Ofgem to Paul Whittaker at Transco National Grid. It is dated
8 2nd September 2002. It is discussing premature replacement charges, and if you turn over
9 the page and look at the second page, just under the indent at the top you will see her saying
10 this:

11 “We also made it clear at the meeting that we would not contemplate any
12 compensation for the stranded costs that arise as a result of this proposal. We had
13 said previously that since the potential for stranded costs had been acknowledged
14 during the price control review, there was no basis for re-opening the control at this
15 stage. In our view, the benefit to Transco of the reduced rental charges ...”

16 – that is under the proposal –

17 “... would come through the introduction of the premature replacement charge
18 which would give Transco some protection against a certain level of stranded costs
19 which might otherwise result through competition.”

20 You can put that away, because that is taking the story out of sequence to an extent. Our
21 key point is that the understanding which Ofgem is that this risk is covered by the price
22 control, and in the discussions they are talking about using PRCs as a way of dealing with
23 this risk to a certain extent.

24 PROFESSOR STONEMAN: Can I just go back to para.2.51 of the Decision. You are talking
25 here about National Grid protecting itself against the costs of competition. Paragraph 2.51
26 basically states that National Grid was concerned that with the introduction of metering
27 competition it would have to reduce its prices or lose market share:

28 “The cost of purchasing new meters had halved over recent years and NG was
29 concerned that it would be forced to reduce its prices to prevent ‘premature
30 replacement’. ...”

31 Is this National Grid trying to protect itself against competition or National Grid trying to
32 protect itself against the impacts of technological advance upon the modernness of its meter
33 stock, or can they even be separated?

1 MR. TURNER: Perhaps they cannot be separated. First of all, by “technological advance”, we
2 are not talking yet about introduction of the new smart meters, we are talking about them
3 becoming cheaper for whatever reason, and National Grid, yes, is concerned that because
4 the new stock coming on-stream now are cheaper, gas suppliers who do not have payment
5 completion arrangements have this incentive to just put in the new one and take out the old
6 meter without bearing the full cost, which they would have done had normal commercial
7 arrangements been used before the original one was put in in the first place.

8 PROFESSOR STONEMAN: Under normal competition would you not expect that if it suddenly
9 comes on the market with a cheaper product you would lose your market to them? You
10 would not have any right to have your market protected just because you invested before
11 they did.

12 MR. TURNER: Yes. You are absolutely right, sir, to this extent: that comes back to the debate I
13 was mentioning at the outset about, “What is the vision of competition in this market?”
14 According to Ofgem, if you do not have these sorts of contracts or protections in place, then
15 normal competition means that if somebody does turn up with a cheaper asset because
16 prices have fallen, you should be able, under normal competition, to put in the new meter
17 because it is to your advantage as the gas supplier. They say that that is normal
18 competition at work. But, if competition in this industry, given the nature of the assets,
19 does mean that before people commercially put in place contracts - like the CMOs have
20 now done with British Gas where they have this PRC protection, the exit charges - then, no.
21 Because somebody is offering a slightly cheaper meter now under this system where people
22 compete on the longer term commitment contracts, you do not replace automatically just
23 because something is slightly cheaper going forwards. It is absolutely at the heart of the
24 case. If you think about things from this point of view - that the way of contracting for
25 these assets, competing to provide them - is normal in circumstances where you have term
26 protection, then the answer to your question is, “No, normal competition would not see that
27 happening”. If you take the CMOs contracts with British Gas, they have put in place with
28 British Gas ordinary commercial contracts which have this protection. Now, just because a
29 year later meters are cheaper, it does not mean that the gas supplier - British Gas - is going
30 to take out their meters and put in slightly cheaper ones because of the normal commercial
31 arrangements it has reached.

32 THE CHAIRMAN: But, as far as National Grid’s business of installing new meters under the N
33 and R Agreement, you presumably benefit like all the other CMOs from the reduction in the
34 cost of buying the meter from the manufacturer. However, your problem is that when you

1 installed all these Legacy meters, meters were more expensive and you had no choice but to
2 buy them at that price and install them. The meters that you are installing now to replace
3 your own Legacy meters are cheaper meters.

4 MR. TURNER: That is right. We have given various sorts of analogy in our pleadings. For
5 example, at one stage we refer to buying a PC for yourself, where you buy a PC and either
6 if you purchase it outright with an upfront payment or if you have bought it subject to a
7 payment completion arrangement, just because something slightly better then comes on to
8 the market, you are not free -- You do not have the incentive actually to simply throw away
9 your existing one and take the slightly cheaper one. The same goes for mobile 'phone
10 contracts, for example, where the normal arrangement is that you have some kind of term
11 commitment and just because there may be something cheaper - or, in fact, in the mobile
12 'phone context, slightly more advanced is often the case. You do not automatically discard
13 your existing one because, as a matter of competition, the people providing these assets will
14 generally put in place some form of term protection so that they do recoup their costs and
15 make money.

16 THE CHAIRMAN: That is obviously something we will have to debate.

17 MR. TURNER: Absolutely. This is Professor Stoneman's point - this is really, although
18 sometimes hidden, one of the points at the very heart of the case. My only observation I
19 would make further on that is that you do see Ofgem itself accepting in its case that
20 payment completion arrangements are a normal form of competition.

21 PROFESSOR STONEMAN: I think this is an issue that will come up again.

22 MR. TURNER: It is going to come up repeatedly, and we will have experts as well.

23 The next thing I would like to do, with the Tribunal's permission, is to look at some of the
24 contemporaneous documents which were omitted from the Decision's assessment of
25 dominance and abuse. I am going to focus the trawl, for reasons of time, on two bundles
26 only: SD2 and a little bundle with BP on the spine.

27 THE CHAIRMAN: Are you going to come back to market definition, Mr. Turner?

28 MR. TURNER: I have not started it yet. This is still the factual context. I am going to try to deal
29 with market definition and dominance this afternoon. The two files we will be almost
30 exclusively will be SD2 and BP. I am going to take this quickly. SD2, if you start at Tab
31 31 -- We are in the summer of 2002. We have a presentation made to the Lattice board (this
32 is National Grid) by Mr. Shoemith (who is one of the witnesses) I want to show you one
33 slide, which is at p.1121. This is National Grid saying, "Well, what are we going to do

1 about the problem that I identified at the outset?" "Mitigation Strategy." There are four
2 primary objectives mentioned.

3 "Lock in maximum possible value of legacy meters." That is the preservation of
4 the value. Then, and I emphasise, "Meet obligation to facilitate competition;
5 manage withdrawal from competitive metering safely and efficiently; continue to
6 meet Gas Act and Licence obligations".

7 Very briefly, the two points you see from that are, "Yes, we did want to try to preserve the
8 value of this Legacy stock which was now in a perilous situation, but we also wanted, and
9 internally directed ourselves by an obligation, to facilitate competition". The reference in
10 the third bullet to managing the withdrawal from competitive metering safely and efficiently
11 was because at that stage National Grid was thinking to itself, "We're going to just get out
12 of this industry altogether".

13 So, that is National Grid internally in the summer of 2002.

14 Now, look at the negotiating dynamics and the balance of power issue. If you go to Tab 30,
15 the previous tab, you have got an internal National Grid e-mail, slightly after the
16 presentation we have just seen, from Malcolm Wesley of National Grid, talking about
17 another of the witnesses for National Grid, Neil Avery. Now, Neil Avery is the senior
18 negotiator on the other side of the table at that stage for British Gas. You will see that
19 negotiations have really started to get going between them at this point. The ideas of a
20 commercial contract are being hammered out. Under "Neil's position was as follows --"
21 you will see that Neil Avery, for British Gas, is telling National Grid that it would be
22 unlikely that they would be prepared to accept an exit charge equivalent to the unpaid
23 minimum bills. So, he is saying, "We're not going to have exit charges which lock in your
24 rentals at the high level - the price cap level. We want something more than that".

25 If you look at the second bullet point, he is complaining that he is disappointed that they
26 have not had indicative prices for even shorter periods on the replacement terms, which may
27 be duration. He says he still professes not to understand why we are not able to do this since
28 we could still be better off in value terms than if we were exposed to the full impact of
29 unconstrained competition. It is clear that they have estimated the damage they could
30 potentially do by ripping out meters rapidly and are using this as the benchmark for
31 negotiating a deal. He said if we could not reach a deal around the 13.5 combination he did
32 not think there would be a deal at all. 13.5 we think means 13 years for the credit meters,
33 five years for the pre-payments.

34 At the end of the bullet points:

1 “Overall it was a difficult discussion, Neil agreed to take the point away for
2 consideration but indicated his view, taking all the points into consideration, there
3 was no longer a basis for a deal.”

4 So that is the British Gas side, and you see there the consideration that they take into
5 account. They are saying: “We can pull out your meters fast and we can inflict all this
6 damage. You will have to do better in the terms that you offer us.” In a nutshell that is the
7 dynamic as between National Grid on the one hand, and British Gas leading the charge on
8 the other. I am afraid although I said SD2 alone, the next logical point is to pick up SD3,
9 but keep SD2 there, and turn to tab 108, because this is where you see one of the other gas
10 suppliers and how they saw the balance of power issue between National Grid and the gas
11 suppliers.

12 At tab 108 you have an email, now March 2004 from somebody at EDF, and that is the
13 company that decides not to sign. You will see at the top “Procurements view”.

14 “From the beginning I have viewed this offer with suspicion...” low price. “If this
15 agreement is such a good deal why offer [£X] to sign (did anybody ask for a
16 discount) why give away [£X] when you don’t have to.

17 At the present time ...”

18 This is the point:

19 “... all risk sits with Transco, we can swap out all their meters at anytime if we
20 wish, in this case. Transco will not recover the cost of the asset if they are
21 removed early, which puts us in a very strong negotiating position. To date
22 Transco have made us an offer so that all risk sits with EDF Energy, do the risks
23 outweigh the savings?

24 Why are we rushing around trying to keep to their timescales, we are the ones with
25 time on our side, we are not sitting with any risk. I suspect Transco are the ones
26 feeling the pressure hence the discount.”

27 Pausing there, that is absolutely right. That was following on from what you have seen
28 from British Gas, the state of the negotiating dynamics between on the one hand National
29 Grid and, on the other hand, the gas suppliers.

30 You can put that away and return to SD2.

31 PROFESSOR STONEMAN: Just before you do that, I asked you a question this morning about
32 selling meters, and I notice in the fourth paragraph here it says that “Transco stated they are
33 not prepared to sell or allow others to work on their asset.” Is that a true statement?

34 MR. TURNER: Can you give me the reference?

1 PROFESSOR STONEMAN: The letter you have just been reading out. The paragraph starts:

2 “The legacy meter rental finishes ...”?

3 MR. TURNER: Yes, I am going to have to explore the point on sale to get to the bottom of that
4 because the relevant person is not here today. As I said, my understanding is that National
5 Grid thought, but not for a very long time, about selling these assets but believed it would
6 not get a reasonable price because without term protection they would not be worth very
7 much.

8 So far as maintaining the assets is concerned ----

9 PROFESSOR STONEMAN: It says: “... not prepared to sell or allow others to work on their
10 asset.”

11 MR. TURNER: Yes, sell is one thing, as far as maintaining the assets is concerned, that may be
12 the case that they were not prepared to allow others to maintain the assets but again, to give
13 you a final answer I will come back to you on that.

14 THE CHAIRMAN: Could you just clarify which parts of that page are confidential because there
15 are some yellow markings of a figure and also some red markings about the names of
16 people. So what is it that is not confidential that we can say about where this comes from?

17 MR. TURNER: I am told that the parts which are surrounded by the red boxes are confidential,
18 and the parts which are highlighted in yellow, which here are the numbers, they are
19 confidential, the rest is not. But in terms of which company this comes from it is not
20 confidential, this is EDF, for example.

21 THE CHAIRMAN: Yes, Mr. Wells points out that you may have read out one of the numbers in
22 the transcript.

23 MR. TURNER: Yes, I may have done and I apologise for that.

24 THE CHAIRMAN: We will make sure that it is excluded.

25 MR. TURNER: I am obliged, I seek to avoid that sort of slip. So one returns to SD2 and if you
26 go to tab 20 there is a file note on the third page, p.961 of what was we think pretty well the
27 first meeting between National Grid and British Gas to discuss principles. There are two
28 points on this. First, point 4:

29 “Rather than specify an agreed level of replacement meters annually they would
30 prefer [British Gas] an arrangement whereby they pay rental for an agreed average
31 annual minimum number of meters that will decline over time. We indicated that
32 subject to further consideration this approach seemed okay in principle provided it
33 yielded a minimum locked in value to Transco.”

1 Now there, what you have is British Gas saying “The structure that we would like to see is
2 what turned out to be the glidepath, an agreed annual average number of meters declining
3 over time. You will see later, and you will hear from Mr. Avery that their concern was that
4 they wanted to achieve by this, and the glidepath does it, stable and predictable volumes of
5 meters for planning purposes.

6 THE CHAIRMAN: What is the difference between those two, what is the difference between
7 specifying an agreed level of replacement meters annually and having an arrangement
8 where you pay rental for an agreed average annual minimum number of meters that will
9 decline over time?

10 MR. TURNER: I do not believe it was intended to be two sides of the same coin. I will check,
11 but I believe the problem with the first course, as British Gas saw it, was that that could be
12 an uneven level of replacement whereas what they wanted was to see a minimum number
13 declining progressively over time. We believe that that is what was intended here. You
14 will have Mr. Avery and you can ask him that when he is in the box.

15 THE CHAIRMAN: Perhaps the difference between an agreed level and a minimum or maximum
16 number of replacements?

17 MR. TURNER: Yes, although you can imagine that it could be structured so as to achieve the
18 same, but all I can say is that it looks as though what they said that they would prefer at any
19 rate is what turned into the glidepath and Mr. Avery gives his reasons for why that was,
20 from British Gas’ point of view, what they wanted.

21 Point 8 over the page one sees British Gas saying in all of this they propose that their rental
22 obligation should be adjusted to exclude certain meters. The principle is they should not
23 pay for faulty equipment or meter changes caused by actions outside their control, and they
24 mention faulty meters, churn – that is the change of supplier; debt driven exchange and data
25 errors, i.e. ghost meters – fictional meters. “Debt driven exchange is the customer requested
26 exchange.

27 So what British Gas are saying is: “From our commercial point of view, what we want is a
28 contract in which we are not having to pay when these meters go or have to be replaced for
29 reasons outside our control.” Our point is that the glide path again, which was set at a level
30 above any allowance for policy meters – these are the inaccurate ones – faulty meters, and
31 the customer related exchanges, perform that function as well.

32 THE CHAIRMAN: It is different though, because I thought you said earlier that the churn ones
33 do not count towards the glide path, whereas the faulty meters and the functionality
34 exchanges do count towards the glide path.

1 MR. TURNER: What happens is that they count towards the free allowance, and the free
2 allowance is set so that there is enough there to cover your needs. It is different in that with
3 change of supplier you are not suddenly lumbered, which British Gas was worried about,
4 with an obligation to rent the original higher number of meters. It is done in a different way
5 for the reason, madam, that you give.

6 Can we then move on from that to tab 52. Tab 52 briefly is an internal email from British
7 Gas, January 2003, in which the bargaining is continuing but you will see under the heading
8 “Data Quality”, that the British Gas man says:

9 “If we look at our metering portfolio, we will see that there are significant numbers
10 of meters without clear age data. How can we use this to our advantage to increase
11 the number of meters we are allowed to exchange, e.g. if the age of a Transco
12 meter is not known, or conflicting data exists about its age then we should add it to
13 the population of meters which we can change.”

14 So what you have here briefly is recognition that within the stock there were a significant
15 number of meters of unknown age. In its internal ruminations British Gas say, “We should
16 bargain to say that these things should be treated as essentially free to exchange”.

17 Then if you turn to tab 66 in the same bundle we are in April 2003. The negotiations have
18 reached a fairly advanced stage so far as British Gas are concerned, but you will see here in
19 this internal email for National Grid at 1.2:

20 “Different contract durations

21 ● Transco offered British Gas a range of contract durations and prices, including
22 prices for longer durations, at the time that the [letter of intent] was being
23 developed. British Gas chose an 18/7 duration as this gave it the best compromise
24 between lower prices and the workload commitments that it had made to its
25 operators.”

26 So you see from this that you do not have the term imposed even as a take it or leave it
27 situation by National Grid, they offer a menu of different contract durations, but associated
28 with those are corresponding prices – the shorter the duration the higher the price that
29 National Grid was going to be asking for. British Gas chooses the one that gives it the best
30 deal bearing in mind the commitment it has made to its meter operators at that time. It had
31 already concluded a contract with Meter Fit all the way back in May 2002.

32 The other point is at 1.4 here, “Tolerance bands and operational flexibility”, that becomes
33 what we call the below line rentals, what Ofgem calls the take or pay band, and it was

1 British Gas who essentially are in favour of this proposal, and the evidence suggests that
2 British Gas were the ones who asked for its inclusion.

3 If you turn over the page a few further points. 2.7 refers to the spreading of policy
4 exchanges over geographic areas, which they wanted to do because of the evidence that
5 they had – again I can give the references. In some areas, as with age of meters, policy
6 meters are not sufficiently thick on the ground for commercial meter operators to go at
7 efficiently.

8 Then 2.9, ability to maintain PPMs, and this picks up, Professor Stoneman, perhaps the
9 point you had made in relation to the EDF document. Here we see:

10 “● Transco is willing to discuss the possibility of continuing to maintain pre-
11 payments meters rented to British Gas if that helps to address concerns about the
12 premature replacement of the prepayment meters.”

13 So what they appear to be saying here is, “If you have got concerns about the premature
14 replacement of our pre-payment meters” – remember those are the extremely subsidised
15 ones – “we are willing to discuss the possibility of continuing to maintain them, if that helps
16 to address your concerns.

17 PROFESSOR STONEMAN: I was asking the other way round.

18 MR. TURNER: I realised that as I was saying it, but you see here that the way that maintenance
19 came in here was as a request to help out British Gas.

20 THE CHAIRMAN: Are you sure that the reference in 2.7 to policy exchanges is the reference to
21 the policy replacement exchanges? I thought that that concept only came up substantially
22 later than April 2003.

23 MR. TURNER: No, the idea of policy meters from National Grid’s point of view replacing
24 meters that needed to be replaced because of their condition had been around for a long
25 time. What came up later was the mechanism in the Legacy MSA for how that would be
26 dealt with under the new contracts.

27 The penultimate bullet, you see that Transco is willing to discuss increasing its tolerance
28 band because British Gas at one stage wanted the BLR band increased if this would help
29 provide British Gas with additional operational flexibility and reduce the possibility of
30 having to pay PRCs. I draw that to your attention because what the gas suppliers want and
31 what British Gas want here is something which actually means, “When we go above the
32 glide path we do not have to pay PRCs calculated on all the future rental streams, less
33 avoided costs for these meters for their lives, we want some arrangement whereby we pay a
34 lower charge if we slip above or below this line”. That became the below line rental.

1 Finally you see, the last bullet:

2 “Transco envisages that exemptions to premature replacement charges would
3 include faulty meters and customer-requested exchanges.”

4 They are brought in. They were intended to be brought in under the allowance for glide
5 path, as indeed turned out to be the case.

6 THE CHAIRMAN: I cannot read on my copy what the pencilled amendment is.

7 MR. TURNER: Nor can I.

8 I will push on. At tab 47 you see an email from Mr. Avery, internal to British Gas , to Mr.
9 Wignall, October 2002, just prior to the letter of intent, the heads of terms that were agreed
10 in December. If you read under “Overview”, which is in a red box, you will see essentially
11 that what he is saying that Transco and National Grid have come down a lot on price.
12 If you turn the page and look at the first two lines beyond the trailing paragraph at the top
13 you will see this, not in the red box:

14 “Iain Taylor [a regulatory man at British Gas] has written to you, warning that we
15 are likely to receive considerable opposition from Ofgem if we implement an
16 accelerated exchange programme and that this could have adverse consequences in
17 other areas.”

18 indicating British Gas’s perception of Ofgem’s attitude.

19 Finally in this bundle at tab 69, a very important document. You should have a slide
20 presentation which I encourage you to read separately, because I will not be covering this in
21 full detail, internal to National Grid about the structure of the PRCs. At the bottom of the
22 first page the author says:

23 “I think it is pretty clear that the ‘averaged’ or ‘single charge’ approach is
24 preferred:

- 25 i) it is simpler operationally ...
26 ii) it is preferable from a legal perspective ...”

27 – I laugh hollowly in view of today –

- 28 “iii) shippers/suppliers will prefer it
29 iv) it is less susceptible to gaming by shippers/suppliers.”

30 This is then developed in the following ----

31 THE CHAIRMAN: What does that mean, “gaming”?

32 MR. TURNER: It meant you have your glide path and if the gas supplier is going to be taking out
33 lots of younger meters, as I understand it, then this could affect the value of the remaining

1 stock, because you will be taking out too many, you could therefore affect the value of what
2 remains. I am going to press ahead while Mr. Rothwell scribbles his explanation on that.
3 Over on p.1297 you see an explanation of the basic concept of what was called “Project
4 Jam”:

5 “... to reduce stranding on legacy meters by incentivising customers to remove
6 Transco meters at an agreed rate (or slower) --”

7 Then there is an explanation of this. You will see from the third from bottom bullet,

8 “Unfortunately we do not have perfect correlation between unrecovered value on
9 individual meters, the age of the meters and when we expect meters to be replaced.
10 In addition, there are a large number of meters whose age is not known. It is also
11 an inherent features of Project Jam that although customers are incentivised to
12 remove meters at no more than a defined rate, they have some flexibility over
13 which meters they can remove. This leads to an alternative approach to PRCs in
14 which an average value is used for all meters, whatever their age or remaining
15 life”.

16 He then goes through the pros and cons of these two different possible approaches to PRCs.

17 If you go to 1301, he says,

18 “In order to apply these charges, we could seek to identify in what year each meter
19 type will be removed: the analytically correct approach is consider each meter
20 type/age [so, that is by type and by age], and schedule these for replacement on a
21 basis consistent with the Jam replacement profiles. This leads to a ‘Glass’s Guide’
22 for meters. However, it has three main difficulties: there are a large number [he at
23 that time thought around 2 million] of ‘unknown’ meters - how should we treat
24 these?; the replacement programme would be updated regularly (at least every
25 year) leading to significant effort to republish the guide; the approach is overly
26 complex so we would struggle to develop systems to implement it”.

27 Then the bullet one below that,

28 “An alternative approach would be to map the portfolio t the required replacement
29 number per year, based on age alone: this is simpler [so, now you are just looking
30 simply at the age of the meter and nothing else], but has or leads to problems (and
31 potential value erosion) because of the mismatch between age and scheduled
32 replacement date/order, and because of the ‘unknown meters’”.

33 Then, the facing page, 1302,

1 “The alternative method is based on the same set of PRCs shown in the graph
2 earlier”.

3 We then talk about the method that was ultimately to be included in the contract. At the
4 penultimate bullet,

5 “It has the advantages that it is simpler to calculate; it more accurately reflects the
6 cost to Transco of meters removed under Jam; it eliminates the opportunity for
7 ‘gaming’ by customers; it removes the perceived unfairness of the ‘youngest first’
8 principle”.

9 I can explain that by the point that if you have a glidepath and they have replaced more
10 meters than allowed under the glidepath, all of differing ages, what age do you assign to the
11 ones that stick out at the end? That is the problem. They were inclined to say, “Well, it has
12 to be the youngest. You should treat those as being the youngest for the purpose of PRCs”.
13 The people on the other side of the table said, “No. No. You should treat it as the oldest”.
14 This was seen as an answer to that sort of issue.

15 Finally, on p.1305 - ‘Other Issues (3) -- Transco’. At the first bullet point,

16 “Shippers are likely to prefer the ‘average’ approach to the age-related charges for
17 the reasons given earlier. What will Ofgem think? Possible concerns: the charge
18 is unreasonable: this was addressed above [that, there, is talking about, ‘Are we
19 recovering too much value?’]; the basic concept of PRCs is anti-competitive, as it
20 ‘locks-in’ customers: our response is that the whole contract benefits our customers
21 and end consumers, and without recourse to PRCs it would be ‘unenforceable”.

22 So, that is the internal thinking document which was the genesis of the structure of PRCs
23 which was ultimately included in the contracts. Now, as quickly as possible I will ask you
24 to pick up the BP file. This contains a little collection of the assessments by all the gas
25 suppliers of the merits of the contracts which were being offered to them by
26 Transco/National Grid. At Tab 2 you have an enclosure of board papers for British Gas
27 dated November 2002. I would ask you to look at p.17. We have a paper by British Gas’
28 Chief Executive, Mark Clare. You see here, if you look at the first page near the bottom --
29 The third from bottom paragraph begins in the box, “The prices for the commercial
30 contracts --“ You will read that to see what those prices actually mean in terms of the
31 replacement of the entire meter stock. So, the contracts with their own operators are based
32 on taking out stock ----

33 THE CHAIRMAN: It is yellow and in red.

1 MR. TURNER: It is. I am therefore not going to refer to the figures. You will see underneath
2 that that they have been working on the opportunity to achieve additional benefits by
3 accelerating replacement of the Transco Legacy meters, and what they thought that would
4 mean and how they would do it.

5 Over the page, "Agreement has been reached 'in principle' --" and there is the rental price
6 which has been agreed. At the bottom of the first paragraph, "The approach agreed ensures
7 that the actual annual replacement profiles align with those in the new commercial contracts
8 and there is flexibility to adopt accelerated exchanges to deploy new technology".

9 In the next paragraph,

10 "The contract will provide significant benefits in the early years, when most of
11 meter stock is with Transco".

12 That is then assessed. They have looked at it in detail, and they have said that it is based on
13 the low prices, the equivalent of an accelerated meter replacement programme of less than
14 seven years based on the value they would get. In other words, these prices under National
15 Grid's contracts are sufficiently low that if, instead, we were to stay on the original high
16 price contracts and simply get people replacing them quickly, you would need to be able to
17 do so in seven years to arrive at the same financial position. They say that,

18 "A seven year replacement programme is not considered to be a realistic
19 alternative option, given the impact that this would have on customers [because
20 they are thinking about customers] and operations. Ofgem are also likely to
21 oppose an aggressive exchange programme".

22 I ask you to note that as well.

23 I am going to go through the remaining ones as quickly as possible. If you go to Tab 3 -- I
24 think you can dispense with that. Let us go straight to Tab 6. This is EDF, who does not
25 ultimately sign the contract. This is a board paper of February 2005. If you turn to p.72
26 you will see their assessment in the second bullet (the first one not in a red box).

27 "The penalty charges under the Legacy contract only become an issue if EDF
28 Energy's strategy is to remove meters prematurely. The contract does not
29 preclude EDF Energy from embracing technologies such as AMR [Advanced
30 Meter Reading] as we are only likely to install it at premises where there is a cost
31 justification (i.e. .difficult to access). AMR could therefore form part of the normal
32 exchange programme."

1 That is important, because Ofgem in its case relies on EDF for the contrary proposition, but
2 it picks up on a comment from somebody in EDF that predates this and we say this is EDF's
3 position.

4 Tab 8 – Powergen. On p.79, 1.3 they report the position of Ofgem:

5 “Ofgem are very keen to ensure that competitive metering does not result in
6 wholesale disposal of good meter assets by newly appointed metering service
7 providers.”

8 That was their perception also. At 1.6:

9 “Centrica (British Gas) have signed the very same Agreements as this and have
10 also appointed new metering service providers. Powergen Retail can do the same
11 if it is commercially advantageous to do so.”

12 No block there on appointing CMOs.

13 “This flexibility greatly minimises any potential regret from signing the
14 Agreement should a new entrant offering more competitive prices emerge.”

15 Then if you turn to p.4 (81 external numbering) just under the ticks in the centre of the page
16 it says:

17 “Powergen Retail has considered alternative metering service provider's prices;
18 these are not competitive with the prices proposed within these Agreements”.

19 So at least at that stage for that gas supplier it has tested the market and finds National
20 Grid's prices under the contracts at that stage are competitive.

21 Tab 13, a further Powergen paper, if you turn to p.135 you will see there the financial
22 evaluation beginning at para. 17, the range of possible scenarios assessed. If you look at
23 paras. 20 and 21, 20 is in the box, so I will not refer to it, but I rely in particular on what is
24 said about the possibilities in the final sentence there.

25 Paragraph 21, which I will read:

26 “Prices obtained in the tender from potential new metering service providers are
27 currently not competitive with the revised Transco rates. To offset the upfront
28 savings and cause Powergen to ‘regret’ entering into the Transco contracts, new
29 provider prices in 2006 would have to be 30% lower than Transco, even assuming
30 500k meters could be replaced annually. The chance of regretting the decision is
31 therefore very low.”

32 Tab 14, the following tab is Npower. In the third paragraph, their discussion in the briefing
33 note to the CEO says:

1 “The major disadvantage of adopting the approach taken by British Gas is that it
2 involves the large scale premature removal of Transco meters. This not only
3 leaves Transco with a serious stranded asset risk, it also creates a situation that is
4 not considered to be in the best interests of the industry as a whole. In particular,
5 the large scale exchange of adequate, fit for purpose gas meters has the potential
6 to create significant customer service issues.”

7 So when they are thinking about it again they all see that accelerated replacement has
8 implications for customer service in the sense that it is a significant customer service issue
9 if you go and disrupt them in order to fit the new meter.

10 Further down in the penultimate paragraph:

11 “The advantage of agreeing a price reduction with Transco is that it not only
12 avoids the need for a mass exchange of workable gas meters it also means that
13 Npower can achieve immediate reductions on all its gas meters.”

14 And this is the point that in any price comparison you have to look at the matter as they did,
15 and all the gas suppliers did, at the level of the across the board savings.

16 Tab 17, still Npower, p.170, under strategic evaluation, third paragraph from the bottom:

17 “Regarding new technology, current thinking is that this is extremely unlikely to
18 be cost effective in the short to medium term i.e. < 10 years. Furthermore, any
19 new technology will almost certainly have to be phased in over time. Under JAM
20 Npower could still phase in new technology when it becomes economically viable,
21 but at the reduced flat rate in the contract. Analysis shows that the impact of this
22 is not likely to be material.”

23 Then:

24 “In addition, signing the JAM contracts does not prevent NPower moving to new
25 gas metering service providers as it is possible to ‘elect’ out of the
26 New/Replacement contract on a region by region basis on four months written
27 notice.”

28 THE CHAIRMAN: That paragraph is a bit confused then, is it not?

29 MR. TURNER: Because of the reference to “New/Replacement”?

30 THE CHAIRMAN: Yes, because you cannot opt out of the Legacy MSA on a region by region
31 basis on a four month written notice.

32 MR. TURNER: You can elect out of the legacy contract in order to allow commercial meter
33 operators to replace the assets, the legacy agreements. You give notice that you wish to

1 have a commercial metering operator replacing the meters, and then the commercial
2 metering operator, if due notice has been given, can then undertake that activity.

3 PROFESSOR STONEMAN: You will still have to pay the PRC?

4 MR. TURNER: If what?

5 PROFESSOR STONEMAN: If below the glidepath.

6 MR. TURNER: Absolutely, yes, that is right. So that all of these assets are subject to the term
7 protection as Professor Stoneman rightly points out, but you are free to engage people to
8 remove these, the point being that there is a very large free allowance which covers what we
9 say is the natural replacement.

10 THE CHAIRMAN: But the people who have signed the legacy agreement but who have not
11 engaged a CMO, therefore all of whose replacement activity is undertaken by National
12 Grid, they are still limited by the glidepath to the number of free replacements they can
13 make even though they are only replacing them with National Grid assets?

14 MR. TURNER: Yes, there is, as it were, term protection for all of the meters that they have
15 rented on to the Legacy MSAs.

16 At the foot of that page:

17 “At this stage it is felt likely that Npower will look to appoint commercial MAMs
18 and procure meters away from Transco in order to gain further benefits. This
19 paper demonstrates that signing the JAM contracts will not inhibit this strategy
20 and will deliver immediate and guaranteed economic benefits.”

21 So in other words, they saw the existence of the Legacy MSAs and signing up to them as
22 compatible with still engaging commercial meter operators to replace meters. If those
23 commercial meter operators replace up to the glidepath allowance no money is paid over by
24 the gas supplier at all. If you go over the glidepath you are then into the early replacement
25 charges. What the gas suppliers are weighing up here are a number of things. First, their
26 perception of the achievability of this and, secondly, and perhaps even more importantly,
27 whether they would want to do it anyway. You will see from a number of these a consistent
28 theme that to engage commercial operators to replace at more than the rate envisaged by the
29 Legacy MSA agreements is not something that they would want to do for other reasons,
30 including in particular customer disruption.

31 If I may therefore complete the survey, that was tab 17. At tab 18 there is an Npower paper
32 of April 2004, and you will see here if you turn to 191 this point being made here under the
33 heading “Strategic Evaluation”, just above the heading “Economic Evaluation”:

1 “We believe it is not possible or desirable to change out meters through an
2 accelerated programme any quicker than the limit determined by the JAM
3 contracts. BGT started a programme of accelerated change out in 2001 (planned
4 10 year programme) but reduced the volume due to customer apathy, data integrity
5 problems and lack of qualified resource to undertake the installations – they have
6 since signed JAM. BG’s current exchange rate is believed to be c3.7% pa.”

7 There you have them saying it is not possible or desirable to change out the meters for an
8 accelerated programme any quicker than the glide path.

9 THE CHAIRMAN: In 2001 that must have been a changing out programme replacing National
10 Grid meters with other National Grid meters?

11 MR. TURNER: That may be. I cannot explain that because we do not have Npower here, but
12 they engaged Meter Fit in May 2002. I think that may be an anomaly.

13 MR. RANDOLPH: (no microphone) ... Meter Fit.

14 MR. TURNER: Meter Fit signed the contract in May 2002 and first removed meters in
15 November 2002.

16 MR. RANDOLPH: I am sorry, but Mr. Turner mentioned Npower, “we had a contractual
17 relationship with Meter Fit”, which is not the position.

18 THE CHAIRMAN: No, we are talking about the reference in that paragraph to British Gas
19 having had a programme of accelerated change out in 2001, and that was within a
20 programme which did not involve Meter Fit because Meter Fit only signed up with British
21 Gas in 2002. So there they must be talking about an accelerated programme replacing
22 National Grid old meters with National Grid new meters.

23 MR. TURNER: I believe, madam, that it is far more likely to be an error because the reference to
24 an accelerated change out did not involve National Grid doing a change out of its own
25 meters. British Gas went down that path from 2002. So whoever wrote this paper, which is
26 Npower, they simply have got the date wrong.

27 I am sorry, it has also been pointed out to me that there is an explanation in that British Gas
28 went out to tender in 2001. So it tendered for this business and said, “We are going to give
29 you lots of work”.

30 THE CHAIRMAN: All right.

31 MR. TURNER: The conclusion at 193, the last two paragraphs:

32 “Signing the JAM contracts allows us to take the guaranteed benefit of lower gas
33 meter rental costs on all our assets [across the board] with immediate effect whilst

1 still allowing us the flexibility to take advantage of potentially even cheaper assets
2 through a realistic replacement schedule inherent within the contract.

3 Not signing the JAM contracts is only (marginally) better if it is possible to replace
4 all our assets at cheaper rates within 7 years, we believe this is not achievable.

5 This option is also of higher risk as the benefits only materialise as the meters are
6 replaced.”

7 as opposed to an immediate across the board benefit from the contract.

8 THE CHAIRMAN: So what they are comparing there is signing the Legacy MSA with staying
9 on the P&M contract?

10 MR. TURNER: Yes, and I have taken this very fast, but that is what all of these people are doing.

11 They are saying to themselves – they have got their financial people to model using a range
12 of sensitivities – what gives them the best benefits. What I am showing to you is that in
13 each case they decide for themselves that they get more value with the Legacy MSA
14 arrangements because of the across the board immediate price reduction effects. It avoids
15 all of the risk and the customer disruption from accelerated replacement. Two further
16 points: that it allows competition because it gives realistic scope, as said here, for bringing
17 on people like Meter Fit and Capital Meters; and in each case here the board papers, where
18 they look at new technology, say, “We do not see this as impeding the introduction of new
19 technology”.

20 We then have Scottish Power at tab 19, March 2004. I give you two references here. One
21 is at p.196, near the foot of the page, “Risk Analysis – Option 2”. Option 2 you will see is
22 the P&M contract that is engaging a commercial operator to take them out under an
23 accelerated basis. They say:

24 “- Exchanging the full portfolio of ScottishPower supplied gas meters over a
25 relatively short time frame will cause significant customer disruption impacting
26 customer service and may lead to customer churn.”

27 They are saying to themselves, “If we go faster than the replacement which is entirely free
28 for commercial operators to undertake under the Legacy MSA, we have customer service
29 issues and concerns”.

30 If you turn over the page to p.197, “Risk Analysis – Option 3”, you will see there that they
31 assess the risks involved in signing the contracts. I shall not read it out, but you will see if
32 you read from there to the end that they assess that it does not cause them a difficulty in
33 terms of bringing on competition or introducing new technology. You see just above
34 recommendations on the final page:

1 “Finally, the contract still provides ScottishPower the flexibility to contract with
2 unregulated Meter Operators for replacement meters. This will derive significant
3 additional customer service and financial benefits which will be taken forward in a
4 future paper.”

5 I have almost completed the survey of all the major gas suppliers. The last one is SSE,
6 Scottish & Southern Electricity, tab 26, another Board Paper, prior to their approval of these
7 contracts. If you turn to p.239, para.4.10 says:

8 “The contract provides flexibility in that Transco only notify a maximum of 3.5%
9 of meters in any year which require to be changed for policy exchange purposes.”

10 So there they are talking policy exchange about the condition based meters –

11 “The remaining 2% are at our behest, and can be used for our principal Customer
12 Service requirement to exchange credit to pre-payment meters and vice versa. The
13 2% is more than enough for our requirements, and can be carried forward to future
14 years if unused.”

15 So again, gas suppliers perspective, “This gives us everything we want and more and does
16 not harm us in any of these directions”.

17 British Gas was the only gas supplier to have engaged CMOs at the time of the decision. It
18 is an issue now in this case advanced not by Ofgem, but by Meter Fit and Capital Meters,
19 that it was the Legacy MSAs which led to the stalling of the tender activity you saw here as
20 indicated in the board papers.

21 Ofgem’s position is that that is not the case, and rightly so, para.2.68 of the Decision. The
22 major gas suppliers were asked by Ofgem what had happened with these tenders, and they
23 all cited other reasons for why the tenders had stalled. I am going to abbreviate this by
24 handing up a note giving the references rather than take you through them. There is only
25 one that I will take you to. If you would pick up PD4, at Tab 93, this is just an example.
26 This is Npower’s explanation -- I am sorry. I will go to Tab 95. They are pretty much of a
27 muchness. Tab 95 - now ScottishPower. At p.2474, in the final paragraph above (7)
28 ScottishPower is telling Ofgem now why it has not progressed with tenders at that stage.
29 Some of this is in the red box.

30 “It must be remembered that metering and associated services are developing
31 markets and options have been limited while new ways of operating are
32 considered. ScottishPower’s approach to developing and implementing a
33 commercial meter operations model is affected by current uncertainties”.

1 Then it refers to two important factors which are not the terms of the contracts, but which I
2 would ask you to bear in mind as factors which did lead to these tenders at that time not
3 progressing. One of those - the first of those mentioned here - is a very important point.
4 We have made the point in our appeal that gas suppliers would not, understandably want to
5 fit new dumb meters with normal term protection if those are going to have to be taken out
6 quickly afterwards to put in smarter meters. So, to try and engage meter operators to
7 undertake the replacement with the basic assets - new ones, even if cheaper - would not
8 have been attractive.

9 THE CHAIRMAN: Your point is that what they do not mention here is because we would be
10 frightened of having to pay PRCs.

11 MR. TURNER: That is right. Nobody said it. Not a single person. Ofgem did not find it (para.
12 2.68 of the Decision).

13 I am going to turn, as rapidly as I can, to deal with market definition and dominance if the
14 Tribunal will give me the indulgence of sitting perhaps a little bit longer.

15 THE CHAIRMAN: Would you like a short break or shall we plough on?

16 MR. TURNER: I am happy to plough on if the Tribunal is happy to.

17 THE CHAIRMAN: I think we will just take a very short break.

18 (Short break)

19 MR. TURNER: Madam, you should have received that very short note giving the references.

20 What you will see from it is that nobody refers to the terms of the MSA. The closest
21 anyone comes to it is, "Well, this investigation into the MSAs throws us into uncertainty".
22 With that, I am going to attempt now to go through the market definition and dominance
23 topic and complete it by the end of today.

24 The key point which is at issue between the parties on market definition is simply this:
25 Ofgem, for its market definition, puts together all the historically installed Legacy meters in
26 the same economic group as the current flow of the new and replacement meters. If you
27 open the Decision at CB1, Tab 1, p.55 you see the impact of doing that. You see there, by
28 reason of doing that, National Grid with these extremely high market shares and the new
29 entrants making slow progress from 2002 through to 2007. Those market shares then
30 become a major element in Ofgem's subsequent reasoning on market power. They are
31 important. National Grid's view is that that approach is wrong in principle. We say it gives
32 a wholly misleading impression of the scale and pattern of competitive activity. To use the
33 words of the EC Commission in their notice on market definition -- If you look at their
34 table, it does not convey meaningful information regarding market power for the purpose of

1 assessing dominance. National Grid's view is that a more informative picture of
2 competitive activity is shown by the table of shares in our Notice of Appeal at Tab 2, here,
3 at p.248. Under para. 263 we have a table which is looking at the picture on the new and
4 replacement basis - who is fitting what. There you see the three British Gas CMOs - UMS,
5 Meter Fit and Capital Meters - all listed in rows in the middle. The total is at the bottom.
6 The percentage of the total - the column on the right-hand side -- By 2005 those three have
7 accounted for more than 50 percent together of all new and replacement activity in the
8 market. It is pretty stable for 2007. There is a little dip for 2006, which is explained in the
9 footnote on the facing page - footnote 1. That is essentially because National Grid itself
10 carried out a larger number of replacements of policy meters in those years because there
11 had been a backlog on the part of the commercial meter operators.

12 There is an issue about whether UMS here needs to be counted as part of National Grid ----

13 THE CHAIRMAN: Sorry. Was what you just said explaining what the 6.7 is?

14 MR. TURNER: No. 2006 - under Total CMO in the table - There is a dip to 49.3 percent from
15 what it was the previous year at 55.3 percent. Then it comes back ----

16 THE CHAIRMAN: That is because of the stepping-in.

17 MR. TURNER: Yes. That is it.

18 THE CHAIRMAN: What is the IGT ----?

19 MR. TURNER: This is gas transporters independent of these arrangements carrying out a very
20 small number of replacements separately from these arrangements. Therefore, not National
21 Grid, not British Gas under any of these commercial arrangements. They are counted
22 towards the total amount of activity of 100 percent.

23 Those are the two competing visions of competition. The question for the Tribunal is which
24 conveys a meaningful picture for the purpose of assessing dominance - market power in the
25 market.

26 If you go back to the Decision, the reason for putting the Legacy meters, the installed assets
27 together in the same market definition as the new and replacement meters is paras. 3.13 to
28 3.15 on p.45. This is the key section. Briefly, para. 3.13 refers to the fact that in Ofgem's
29 view the characteristics and intended uses of Legacy installed meters and new and
30 replacement meters do not differ. The distinction between them is said to be an invention
31 of National Grid's by means of these contracts. In para. 3.14 Ofgem makes the point that
32 the replacement meters, by their very nature, are a good substitute for Legacy meters.

33 Everyone agrees that they provide a very strong competitive restraint on National Grid and

1 did so in its bargaining over the terms of continued provision of the installed Legacy
2 meters.

3 In Ofgem's skeleton what they say is this: market definition is all about competitive
4 restraints, as we know. They refer to the Commission's notice on market definition for this.
5 Therefore, it must follow that Legacy and new and replacement meters are all in the same
6 market because National Grid itself not only accepts, but urges on you, that the replacement
7 meters exert a strong competitive threat. Our response is this: You first have to remind
8 yourself of the purpose of the market definition exercise, which is that it is a step in
9 assessing market power. I will not take you to the OFT's guidance, but it is well-known.
10 We obviously do not deny that Legacy and new and replacement meters have the same
11 physical characteristics and intended use, but that competitive conditions are completely
12 different. The key distinguishing point about the installed Legacy meters, and particularly
13 for the credit meters which are the focus of this case, is that the major costs of installing
14 them are sunk. The vast majority of the installed stock cannot be economically refurbished,
15 and the forward-looking costs of providing these meters are, by that reason, because of
16 these vast sunk costs, extremely small. There is virtually no maintenance activity of credit
17 meters while they are on the wall at all. For that point, the Decision itself says that that is
18 correct at para. 2.21. This fact gives installed meters a huge cost advantage when it comes
19 to the gas supplier making a replacement decision. It is a highly relevant economic
20 difference between installed meters, on the one hand, and yet-to-be-installed meters on the
21 other. That is why we say that in what we say are normal circumstances - which is where
22 gas suppliers will have committed to pay for the sunk costs, either through a sale or through
23 some payment completion arrangement - installed meters will not generally be replaced
24 where they are fully functioning by similar, but slightly cheaper replacement meters. They
25 will be replaced when they need to be replaced for other reasons, such as fault or
26 inaccuracy, or because the gas supplier wants to institute a customer-related exchange and
27 move the consumer on to a pre-payment meter.

28 Now, subject to the possibility, of course, that new technology might come on stream and
29 that that will bring, itself, enormous cost savings of one form or another, in that case what
30 you still do is weigh up those cost savings against the huge cost advantage of continuing to
31 use the installed meters. The fact that in normal competitive circumstances gas supplies
32 would not contemplate removing a fully working meter in order to replace it with a similar,
33 but slightly cheaper meter of the same kind, is fully supported by the evidence of BGT's
34 commercial contracts with the CMOs. After the date of the Decision Ofgem became

1 uncertain whether the contracts between British Gas and the CMOs involved payments of
2 PRCs if British Gas said to itself “There are cheaper meters out there now I would like to
3 replace my installed Meter Fit meter with something cheaper.” So Ofgem wrote to the
4 parties to ask them what the position was, and the answers, which I ask you to look at are in
5 bundle CR3 at tab 191. What happened was Ofgem wrote to British Gas and to each of the
6 CMOs and said: “What is the position here? Are charges payable or not?” The answers
7 were very revealing. If you turn first to p.928 you have British Gas’ response. I am told it is
8 not clear whether this is confidential despite the marking so I will speak accordingly. You
9 will see the title at any rate.

10 MISS CARSS-FRISK: We believe it is confidential.

11 MR. TURNER: It should have been marked then. You will see the title: “Like-for-like
12 replacements of installed CMO meters” ----

13 THE CHAIRMAN: Well where would you like us to read up to?

14 MR. TURNER: Look at para.10 at the foot of that page and it is the second sentence, beginning:
15 “There are ...” . I cannot myself see why this is confidential at all, and it is a salient fact for
16 the Tribunal, but there you are. That is what British Gas thought about the matter.
17 You can also go back to the position of Meter Fit in response to the same question, p.923 at
18 para. 12 at the foot of the page. If you just drop to the foot of p.923. I can tell you that the
19 response of CML, which we could also go to is to the same effect. You can now put away
20 CR3. This points up the fact particularly what British Gas says about the circumstances in
21 which it was engaged in this sort of replacement, that new and replacement meters do not
22 compete against fully functioning installed ones in the same way that they compete against
23 each other for the opportunity to replace an installed meter.

24 Moreover, if you think about it from another direction covered in Dr. Williams’ expert
25 report, if you take an installed legacy meter, say, at 15 Arcadia Avenue, that does not
26 compete against a new and replacement meter to supply the customer next door or
27 anywhere else, apart from in its own location. The legacy meters with their sunk costs are
28 truly in a world of their own unlike new and replacement meters. They do not compete
29 against other legacy meters, and nor do they compete against new and replacement meters
30 for meter provision in any other locations.

31 PROFESSOR STONEMAN: Can I just ask you a question on definitions?

32 MR. TURNER: Yes.

33 PROFESSOR STONEMAN: Does a New/Replacement meter become a legacy meter as soon as
34 it is installed?

1 MR. TURNER: Yes, thank you for pointing that out. Under the definition I am adopting, which
2 is the practical and economic definition, yes.

3 PROFESSOR TURNER: So the moment it is installed the New/Replacement meter becomes a
4 legacy meter?

5 MR. TURNER: Yes.

6 PROFESSOR STONEMAN: So why is it a market for a year you have here instead of an
7 instantaneous market?

8 MR. TURNER: I am sorry, “market for a year”?

9 PROFESSOR STONEMAN: All right, that is beside the point. It is like differentiating between a
10 new car and a second hand car. You are saying there is a new car market and there is a
11 second hand car market and ne’er the twain shall meet, but as soon as you get your car out
12 of the showroom it is second hand.

13 MR. TURNER: That does shine a light on a difference here, which is that the installed legacy
14 meters cannot become part of a second hand market, that is a key difference with the
15 example that you have just given, in that you can actually have second hand cars competing
16 for customers in the same way, that is the point about this sort of asset, it cannot do that.

17 THE CHAIRMAN: I think the point is that what is the value or volume of this market which you
18 posit exists if, as you say, the product is only in the market for a very short time. The table
19 that you showed us, giving the market shares and the volumes imply that the value of the
20 New/Replacement market is assessed by looking at how many you replace during the
21 course of the year. But then the product is new meters bought during that year rather than
22 new meters. That is what I also find difficult. How do you value the market when, as you
23 say, the product changes its nature instantly. Because in that table of market shares some of
24 those meters will have generated one month, some two months, some three months, some
25 four months of rental, so all those will have a different value, even though they are exactly
26 the same product as you would look at it.

27 MR. TURNER: The answer is New/Replacement does not have to be looked at – I now
28 understand your question – on a year by year basis at all, because what it is showing you is
29 the extent to which different providers, and there are many different providers of these new
30 and replacement meters, are competing against each other which they typically do in a
31 tendering context, for the business of the gas suppliers, and it gives some indication of the
32 extent to which they are successful as against each other in doing that. The year by year is
33 not material to that, it could not have been presented in any other way.

1 So far as legacy meters are concerned, the point is that once that competition has taken
2 place in the normal world, you have then got meters which go on the wall, the costs are
3 sunk and except in funny circumstances such as those which led to the negotiation in this
4 case you do not bargain over the terms of their continued provision because they are
5 covered by the payment completion arrangements, they are there, they cannot be used to
6 compete against anybody for any other business, they are different.

7 What I am seeking to identify is that when you are looking at competitive activity you have
8 a completely different situation with people competing for the business of gas supplies to do
9 replacements.

10 THE CHAIRMAN: Then how your case has so far been put, at least how I think Ofgem have
11 interpreted it, because they have said in their skeleton that you only challenge the finding of
12 dominance in the event that you managed to establish that there are these two relevant
13 markets.

14 MR. TURNER: That is not correct, they have said that and I can tell you categorically for the
15 record that is not correct.

16 THE CHAIRMAN: What you are saying now is not really a market definition point, even on that
17 98 per cent market share there is ----

18 MR. TURNER: Countervailing buyer power.

19 THE CHAIRMAN: No, no, not the countervailing buyer power point, but rather the bidding
20 markets point which is that you may have this huge share of legacy meters, but the
21 important question is does that help you when you are bidding for new business. I am not
22 sure whether your point is ----

23 MR. TURNER: Let me see if I can clarify. Market definition and dominance, they do go
24 together, market definition is the first step. The reason why it is important here is because,
25 as you have seen from Ofgem's reasoning in the Decision it says: "Let us see what the
26 market shares of everybody are in table 4. National Grid has these continuing, very high
27 market shares, that in itself creates some overwhelming presumption of dominance, and
28 they say even super-dominance, although we do not need to rely upon it.

29 My first point is that we say, no, that is not right at all for the reasons I am giving you now,
30 which is that market definition, the exercise is about, looking at whether the products are
31 subject to the same competitive conditions, you have given a completely non-meaningful
32 picture of the scale and extent of competitive activity actually taking place. If you want to
33 see how healthy the market is, the competitive metering market, you should be focusing

1 your attention on the bidding side, on the new and replacement side, that is where the
2 competitive action naturally is.

3 THE CHAIRMAN: Why do you have to go so far as to say there are two relevant product
4 markets?

5 MR. TURNER: Because if you treat them as one relevant product market you then do what
6 Ofgem has done in table 4, and you say, “Look at this, National Grid has got these vast
7 market shares, that is a strong indicator that it is dominant and has market power”. Perhaps
8 I should say that it maybe does not matter where you label this or how you characterise it.
9 You can present it in that way if you like, but it does not give you any meaningful
10 information when you are trying to work out whether National Grid has market power in the
11 competitive metering market.

12 We do then come on, when we turn to Ofgem’s discussion of dominance, to look at barriers
13 to entry and expansion. Madam, you are right that there, when you get on to that, Ofgem go
14 on to say, by reason of the huge installed base, National Grid has advantages in competition,
15 and they say at 3.74, we will come to that, that in carrying out new and replacement work.
16 Then their argument is that there is some advantage when you are carrying out the new and
17 replacement work. I do not want to anticipate my point too finely, but what we have said
18 about that is, “Where do you identify what this competitive advantage is, how does that
19 arise?” It is not stated in the Decision.

20 Market definition – I am simply starting with this to make quite an important point about
21 the nature of the assets, which is the difference between some assets on the one hand, and a
22 situation where you are bidding as a provider for the business of customers without the
23 meters having already been put on the wall.

24 Does that help at all?

25 THE CHAIRMAN: Yes.

26 MR. TURNER: I am grateful. I will quickly ask you if you have CB1 there, tab 2, our notice of
27 appeal. If you go to p.226 – I shall not ask you to read all this now – our point about
28 lumping these all together for the purpose of a tabulation like Ofgem’s are set out here at
29 202. At (d) on p.227 we set out some of the differences between the conditions of
30 competition in relation to negotiations over the Legacy Meters on the one hand, and over
31 the page at 228, (e) by reference to the position in relation to new and replacement meters.
32 Our point there is that the bargaining is different. To try to lump this all together and say
33 there is a single integrated market definition is just wrong. Ofgem’s answer is that the
34 threat of replacement is the competitive constraint – this is the point now made in the

1 skeleton. If it is a very strong competitive constraint, replacement meters threatening to
2 remove the installed meter, then they should be treated as being in the same market. We
3 agree entirely, of course, that the threat of replacement is a major competitive constraint on
4 National Grid's ability to bargain for the continued provision of the installed meters. It was,
5 and you have seen that in play in one or two of the documents.

6 That does not necessitate that you must count new and replacement meters as part of the
7 same overall market in market definition with the installed legacy meters. I will show you
8 why. They have misunderstood the EC Commission's Notice which does not say that and
9 actually makes clear that the contrary is the case. If you pick up A1 and you turn to tab 22,
10 you have there the Commission Notice. For your reference, at the end of para.2 is that
11 sentence I quoted from about how market definition is all about conveying meaningful
12 information as regards market power.

13 Competitive constraints is dealt with on the following page just above 13, and it talks about
14 the importance of competitive constraints. If you go up to 14 on p.457 the Commission
15 points out:

16 "The competitive constraints arising from supply side substitutability other than
17 those described in paragraphs 20 to 23 and from potential competition are in
18 general less immediate and in any case require an analysis of additional factors.
19 As a result such constraints are taken into account at the assessment stage of
20 competition analysis."

21 So what it is saying is that certain matters, such as the threat of potential competition, are
22 not something that feed into the market definition, they are taken into account in the wider
23 assessment of market power.

24 If you turn over the page you will see that both in relation to supply side substitutability,
25 para.23, and potential competition at para.24 – if we take, for example, para.24, "Potential
26 competition":

27 "The third source of competitive constraint, potential competition, is not taken into
28 account when defining markets, since the conditions under which potential
29 competition will actually represent an effective competitive constraint depend on
30 the analysis of specific factors and circumstances related to the conditions of entry.
31 If required, this analysis is only carried out at a subsequent stage ..."

32 – the point being that in the case of the new and replacement meters, meters which are not
33 yet installed, meters in some cases which may frankly not even have been made, it is the
34 threat of replacement which exercises a competitive constraint, it is not a physical meter

1 which is exercising the competitive constraint and falls to be subject to the same overall
2 product market definition. The simple point is that to exercise the competitive constraint
3 does not mean that you have to be counted within the same market definition.

4 PROFESSOR STONEMAN: I saw this as a demand substitution not supply constraint. Basically
5 what you have is two products here, the new and replacement meters and the legacy meters.
6 Your argument is that the new and replacement meters do not compete with the legacy
7 meters, but you have spent the last two hours this afternoon telling us that the nature of the
8 contract signed by the owners of legacy meters will determine how many new and
9 replacement meters from CMOs are on the market – in other words, the price and contract
10 of the legacy meters affects the demand for new and replacement meters and the prices at
11 which they are sold and the contracts under which they are sold.

12 MR. TURNER: Absolutely.

13 PROFESSOR STONEMAN: Therefore, there is demand side substitution, and that is para.15,
14 which then says it is one market.

15 MR. TURNER: With respect, no, they exercise and of course we accept it as part of our case, a
16 very major competitive constraint. Yes, replacement meters replace installed meters. The
17 question that we are faced with at this stage is a purely technical one about whether it is
18 informative to put these together in the same overall market when you are calculating
19 market shares and drawing conclusions about market power from those market shares.
20 What I have drawn attention to, I hope, is that the Commission's Notice itself points out that
21 there is a range of different things that exercise competitive constraint but can do so from
22 outside the market. They are still taken into account in the assessment of market power. If
23 you are trying to create a tabulation of market shares from which you want to draw
24 conclusions about if there is really market power, that is not the way to go about it.

25 PROFESSOR STONEMAN: I think what we have in front of us does not actually say that you
26 draw the line to the market as to where it is informative to do so. It says there are certain
27 guidelines as to where you decide the market limits are, and that you analyse. There may be
28 some extra market effects, but the informativeness is not a character of dividing the market.

29 MR. TURNER: All I can do is refer back. Because of the time I am going to leave the point
30 there, save to refer back to para. 2 or para. 3 of that Notice where the Commission itself
31 says, "Why are we engaging in this sort of exercise in the first place? What we are trying to
32 do is create market shares which will then give us a good picture as competition assessors of
33 market power". My point is that you have two very different situations of conditions of
34 competition and that although a competitive constraint of a very high kind is imposed by the

1 threat of replacement, it is not meaningful to arrive at the market share tabulation which
2 Ofgem has in Table 4 of its decision and say, “Well, that must tell you that National Grid
3 has market power”.

4 Can I, in view of the time, move on? I will make one final comment only about market
5 definition, which is that to the extent it is of interest to see whether UMS should be counted
6 with National Grid metering and make only one point - which is that Ofgem, in its Decision,
7 rides two horses because when it comes to trying to analyse the effect of the Legacy MSA
8 contracts and whether they have had adverse effects, UMS is looked at as the victim. When
9 it comes to this market share tabulation to see whether UMS should be counted alongside
10 National Grid and indicating market power, it puts it in the other box. I will deal, as
11 necessary, in the closing submissions with any point my friend makes about that.

12 May I turn then to dominance?

13 THE CHAIRMAN: Just one small point. The geographic market. There was a point which
14 Ofgem raised in their skeleton that you had seemed to be making a challenge to the
15 geographic market definition in the Notice of Appeal, but it did not appear in the skeleton.
16 Perhaps you can clarify what the position is on that?

17 MR. TURNER: It is not a point that it is going to be necessary for you to resolve. What we are
18 saying is that if we are right that you should be looking - if you are really interested in the
19 amount of competitive activity - at the bidding for the new and replacement contracts, and
20 that flow of work -- that that tends to be organised on a regional basis. But, the key point is,
21 in all of this, whether Ofgem’s tabulation in Table 4 is meaningful when we turn now to
22 dominance, or not. Where does it really get you?

23 Now, to conclude on that, what we know is that what that tabulation shows is that it adds up
24 the total share that National Grid has of installed meters, and looks as against that, at the
25 share enjoyed by new competitors. It invites the reader of the Decision ----

26 THE CHAIRMAN: That is on a volume measure, is it, there? Or, is it on a value measure?

27 MR. TURNER: I believe it is on a value measure.

28 MISS CARSS-FRISK: (After a pause): It is volume actually.

29 MR. TURNER: It is on a volume basis. (After a pause): Yes, that is right.

30 THE CHAIRMAN: Where is that again?

31 MR. TURNER: That is on p.55 of the external numbering. (After a pause): It does not say that it
32 is volume, but I am very happy to accept my friend’s clarification.

1 THE CHAIRMAN: Yes. It is just a rather odd way of expressing market share when you are
2 talking about provision of the service really rather than the provision of the meter.
3 But, it is using it, I suppose as a proxy for that.

4 MR. TURNER: Yes. More particularly, our point on this approach is that, yes, that is the share
5 taking into account that National Grid has all these meters on the wall because of its historic
6 position. What is it going to tell you about market power? Now, Ofgem relies on three
7 factors, it is common ground, to establish market power: (1) this market share table; (2)
8 barriers to entry and expansion (if you have the Decision, that is para. 3.66 on the next page,
9 to para. 3.74); (3) absence of buyer power (para. 3.75 to the end). Market shares I will say
10 no more about. Barriers to entry and expansion I will say something about, and then buyer
11 power.

12 Barriers to entry and expansion. If you go to the first sentence of para. 3.66 of the Decision,
13 what Ofgem says is,

14 “Barriers to entry and expansion arise when an incumbent undertaking has, by
15 virtue of incumbency, a competitive advantage over potential or new entrants”.

16 What is this advantage? You run through and you come to the end of the section at 3.74.

17 “National Grid has itself recognised it had, at the time of signing the MSA
18 contracts, and continues to have, significant economies of scale and density
19 resulting from its installed base of meters. This is not surprising given that it still
20 has a market share of 89 percent. This gives National Grid a significant advantage
21 in carrying out new and replacement work”.

22 Now, quite naturally, what the Decision is saying is that by reason of something to do with
23 its possession of the installed base, National Grid has got this advantage in carrying out the
24 new and replacement work. That is the source of the market power. The intermediate
25 paragraphs, between 3.66 and 3.74, are meant to be explaining where this supposed
26 advantage over new entrants comes from. I invite you briefly to look at those. Paragraph
27 3.67 is simply about the Oft guidelines. Paragraph 3.68 is referring to characteristics of the
28 market which make new entry and expansion difficult in the short space of time for
29 anybody, such is the fact that gas meters are long-lived assets and they only come up for
30 replacement infrequently. The work is fairly sparse. It is not like supplying oranges to the
31 supermarket, or anything like that. But, that affects National Grid’s carrying out of the new
32 and replacement work in the same way as competitors. Paragraph 3.69 explains that
33 unless National Grid sells the installed meters, new entrants have to undertake new and
34 replacement work. But, there is no suggestion, clearly, that National Grid should, as a

1 matter of obligation of some kind, be actively marketing its Legacy meters even if (to pick
2 up on Professor Stoneman’s point) anyone actually wants to buy them at a reasonable price
3 without there being any PRC protection. That is why undertaking new and replacement
4 work is, as Ofgem assuming here rightly, the real competitive arena.

5 Paragraph 3.70 - what does this say? This makes the point that the fact that there are
6 installed long-live meters already in households throughout the country is affecting the flow
7 of replacement opportunities for new entrants. Again, they do not come up that often, those
8 opportunities. That is perfectly true. But, where is the competitive advantage for National
9 Grid over other providers, the new entrants, of new and replacement meters in the
10 competitive world? National Grid faces the same issues.

11 Paragraphs 3.71 and 3.72 and indeed the example in 3.70 itself are all not really concerned
12 with economies of scale. I just draw to your attention that they are referring to density. If
13 you look at what is being said there is the need to be able to achieve efficiencies by visiting
14 meters in the same close geographic area. We do not dispute that there are economies of
15 density in carrying out meter installation work; both parties agree on that. What we do
16 dispute again, and which is not covered by anything here is that National Grid has
17 advantages over others in achieving any such density because of the installed base of
18 meters.

19 So finally you come back to 3.74, the end of the section, and we expect to see the answer to:
20 “Why does National Grid have these advantages over new entrants?” as it says at the end of
21 there: “in carrying out the new and replacement work.” It turns out it depends on the claim
22 here that National Grid has itself recognised that it has significant economies of scale and
23 density resulting from its installed base of meters, giving it a significant advantage in
24 New/Replacement work, that is said and found. But that is mistaken. National Grid has
25 never said that it benefited from any economies of density which, by its nature, if you think
26 about it can only mean replacement work and new installations.

27 The only basis for the finding here of these barriers to entry and expansion, and this
28 advantage of National Grid is footnote 222 and that refers to a comment which remains,
29 even to us, somewhat obscure in a slide presentation and a comment from National Grid
30 about it in general terms.

31 “This comment appears to be a recognition that the legacy business has some fixed costs
32 and therefore a higher number of meters would lead to a lower unit cost so supporting a
33 platform for growth in the future”,

1 So far as we can tell what this refers to must be a time before UMS is split off as the new
2 and replacement entity within the National Grid group and where you are thinking about
3 integrated work and whether some of the operations you have to carry out for your legacy
4 meters might give you some costs savings, lower unit costs, in new and replacement work.
5 But we cannot take it further than that.

6 To summarise on this second point, the barriers to entry and expansion and the incumbent
7 advantage it is not there, not made out. I hope that that, to some extent is at least throwing
8 light on why we are saying the key question for you, however you approach it is: where are
9 the advantages, where is the market power.

10 We turn then to the last leg, buyer power. Here Ofgem is proving a negative. It is saying
11 there is not countervailing buyer power. Our case on this is twofold.

12 THE CHAIRMAN: Just pause there for a moment. You have been on your feet all day, Mr.

13 Turner, I wonder whether you would prefer to break now and start perhaps a little bit earlier
14 tomorrow morning in order to be sure of finishing at lunch time?

15 MR. TURNER: If it is not having my cake and eating it, and if it is convenient for the Tribunal, if
16 I push on for a bit now, and we can start early then that will minimise the chance that I will
17 have to go over.

18 (The Tribunal confer)

19 THE CHAIRMAN: Yes.

20 MR. TURNER: I am very grateful indeed.

21 THE CHAIRMAN: Thank you.

22 MR. TURNER: I am extremely grateful. You have our skeleton somewhere in this mass of
23 paper and our case on buyer power is set out in paragraph 28. CB2, tab 14 if you have it in
24 the bundles as opposed to separately. Our case on buyer power is really twofold, reflected
25 by 28(a) and 28(b) in the skeleton.

26 The first point is about structure. National Grid's bargaining power was fundamentally
27 weakened by the fact that its costs were sunk, by the regulation of its prices and by the
28 realistic threats of accelerated replacement programmes which were open to the gas
29 suppliers who could simply remain on the 'no notice' P&M contracts.

30 THE CHAIRMAN: Which tab?

31 MR. TURNER: CB2, tab 14, p.865 of the bundle numbering. What you will see there is that we
32 have simply dropped it into two categories our position on this.

33 The first is a structural set of points, the second relates to the contemporaneous evidence
34 and I am taking first the structural point, what we say there is that the combination of these

1 various factors at the time implied that National Grid could not have, and in fact has not
2 been able to negotiate a contract that even recovered its sunk cost of the meters. We did not
3 have the power to impose disadvantageous terms on the gas suppliers whom Ofgem have
4 placed at the hub of its competitive market in this industry. It is their function to decide
5 on the rate of replacement of installed meters that best suits their needs and their customers.
6 We did not have the power to act to their disadvantage. This is an argument that we
7 advanced prominently in the investigation but you will have seen from the Decision that it
8 does not feature, or even gain a mention as part of National Grid's case, If you turn to
9 para.3.59 for example, in the Decision, there is an overview of National Grid's arguments
10 on dominance (p.53) but this point which we heavily relied upon was not there.

11 Before dealing with Ofgem's specific responses to what we have said in our skeleton, I take
12 you to the latest important statement by the European Commission of its own approach
13 when it is assessing dominance. Those are in the very recently produced enforcement
14 guidelines which are in bundle A6 at tab 20, p.5. If you have that you will see on p.5, a
15 heading under "General Approach to Exclusionary Conduct", "Market power." At para. 10,
16 if I direct you to the bottom of the page, the last sentence there says, after recording the test
17 of dominance:

18 "This means that the undertaking's decisions are largely insensitive to the actions and
19 reactions of competitors, customers and, ultimately, consumers."

20 We will be inviting you to find that the actions, reactions of customers in this case were
21 very important to the deals that were done, and to the Legacy MSAs and its terms.

22 Paragraph 11:

23 "The Commission considers that an undertaking which is capable of profitably increasing
24 prices above the competitive level for a significant period of time does not face sufficiently
25 effective competitive constraints and can thus generally be regarded as dominant."

26 The expression "increased prices" is used as shorthand for various ways of distorting
27 parameters of competition. It says at the end of para. 11:

28 " – can be influenced for the profit of the dominant undertaking and to the
29 detriment of consumers."

30 It is part of the test. Again, our point is that there is no evidence of National Grid being able
31 to impose terms in the Legacy MSAs for its profit and to the detriment of consumers. On
32 the contrary.

33 Paragraph 12, the second and third bullets of the three, refers to taking into account in the
34 assessment first, at the second bullet:

1 “Constraints imposed by the credible threat of future expansion by actual
2 competitors or entry by potential competitors (expansion and entry).”

3 Here it was the threat of replacement by the CMOs. Then:

4 “Constraints imposed by the bargaining strength of the undertaking’s customers
5 (countervailing buyer power)”.

6 - both of which we rely on in this case.

7 You can put away A6. In bundle CB2 you should have Ofgem’s skeleton which shows how
8 it attempts to meet National Grid’s two points on buyer power. That is at tab 15 beginning
9 at 907. It deals with these points at paras.60 to 67. I am going to deal first with what they
10 say about the structural points. If you go to 63.2, because these are not dealt with in
11 precisely the same order, they say:

12 “... there is clear evidence that the suppliers could not rely on the P&M terms
13 remaining in place, because the Authority has indicated that it intends to remove
14 the price caps when effective competition has been established. There would
15 therefore be a degree of uncertainty as to the level of prices that could be charged
16 by NG in the future. Contrary to NG’s assertion, suppliers would have no certainty
17 that the advent of competition would mean that NG would not raise its prices.”

18 Our answer to that, in short, is that Ofgem has not offered a coherent answer to our point
19 that the gas suppliers in the negotiations did have the comfortable fall-back option of the
20 regulated terms of dealing. Their point that the price caps could have been lifted once there
21 was effective competition so that the suppliers have no secure fall-back option is a false
22 point. If there was going to be effective competition then National Grid is not able, *ex*
23 *hypothesi*, to exploit market power and raise its prices.

24 Moreover, as you have seen, although it was a very quick survey, all the gas suppliers
25 assessed the options as an alternative to the MSAs as being these regulated terms of dealing.
26 Nobody refrained from doing so on the basis they thought they were at risk that these price
27 caps would be lifted at any time and National Grid was going to raise its prices.

28 Finally, on the same point, at the time of the MSA negotiations Ofgem’s own senior
29 economist certainly appreciated National Grid’s point here on market power, and he used it
30 as a part of the reasoning in the memorandum to the Ofgem management committee in
31 February 2003. I have referred to that briefly before, but it is convenient now to look at it.
32 It is in SD2, tab 56. This was the decision of Ofgem at that time about what to do in
33 relation to Transco National Grid’s proposed charges. I referred to this briefly in the extract
34 from the reply. It is a document that we will be no doubt coming back to, but for present

1 purposes if you go to 1244, the last page, para.15, we see the point that the Ofgem senior
2 economist says:

3 “Allowing Transco to sign commercial contracts with shippers would seem to be
4 the most effective means of ensuring an efficient industry outcome. Transco’s
5 licence requires them to provide meters upon shipper request and these meters
6 would be provided on the current price controlled terms with no premature
7 replacement charge unless a shipper requested otherwise. This weakens the ability
8 of Transco to abuse market power in setting the terms of its metering contracts
9 since the regulated default option is always available.”

10 The point there is, and it is a good point, it has not been met and Ofgem appreciated it at the
11 time but did not record it in its Decision.

12 Going back to Ofgem’s skeleton, the next point is at 63.1. In short, this is referring to a
13 suggestion that National Grid’s position in the negotiations with gas suppliers was actually
14 strengthened because it had sunk its costs. You will be aware that National Grid says it is
15 the opposite. We say that that is simply perverse. The evidence of what happened in the
16 real world is vivid and Dr. Williams, our economist, gives his opinion about what he, as an
17 economist, would expect to happen in such circumstances where somebody has sunk their
18 cost in the asset in this relationship specific way with a gas supplier and then there is
19 bargaining about the continued term of its provision. Now the provider is in, we say, an
20 obviously weakened position. Nor does Ofgem grapple anywhere with the point that we
21 emphasise about the enormous sacrifice in recovering sunk costs that National Grid had to
22 concede in bargaining for its price for continuing to provide the legacy assets unaddressed
23 and relevant to the question of market power, taking decisions largely insensitive.

24 Paragraph 61 of Ofgem’s skeleton argument next is about the evidence. This is my second
25 limb, the contemporaneous evidence, some of which you have seen on a quick survey.
26 Ofgem, in the Decision at paras.3.86 to 3.88, which we will look at perhaps in a moment,
27 says that the contemporaneous record shows that National Grid knew that it was in a strong
28 negotiating position as against the gas suppliers. What it does, and perhaps we should look
29 at that straight away, 3.86 to 3.88 in the Decision, which begins at the foot of p.60, is to
30 pick out at 3.86, 3.87 and 3.88, three quotations out of context, and we deal with this
31 thoroughly in the notice of appeal which I refer to on this point, and they ignore the
32 overwhelming evidence from the gas suppliers, all of which was on their case file, entirely,
33 in which they show the awareness of the strength of their position. As I have shown you,
34 that does not just include British Gas which led the charge and Mr. Avery, from whom you

1 will hear. I showed you also, for example, the assessment internally from EDF.

2 Specifically, in the skeleton Ofgem now focuses in on one of these extracts - just one. That
3 is the extract cited in para. 3.88 of the Decision. It says that,

4 “This shows that National Grid’s own contemporaneous assessment was that there
5 was a low competitive threat from CMOs”.

6 It says that in para. 61 of its skeleton. In fact, Ofgem has misquoted its own Decision
7 because if you look at 3.88 the reference was not to CMOs - it was to non-BGT suppliers as
8 opposed to British Gas at that stage. But, more importantly, there is the point which you
9 will find developed in our Notice of Appeal - I am not going to take you there now - about
10 what this was about. This related to brief internal deliberations about whether to re-open the
11 MSA negotiations at a very late stage in order to try to improve the deal at that time for
12 National Grid. They ultimately did not go ahead and do that. I will give you the reference
13 in the Notice of Appeal - paras. 352 to 354 at p.278 in Tab 2.

14 THE CHAIRMAN: What was the time at which that internal deliberation -- I mean, what was
15 the date of that?

16 MR. TURNER: Let me just turn then in Tab 2 to p.278 and give you the answer there. (After a
17 pause): At para. 352, at p.277, it refers to an attachment to an e-mail sent at a late stage in
18 the negotiations on 7th October, 2003. So, it is in the Autumn before this contract is signed
19 with British Gas, which is January 2004. You will see that it is a Mr. Martin Cook in
20 National Grid internally saying, “Hold on, everybody. The climate has changed here.
21 Competitive metering is not taking off as fast as we thought it would. Let us try and go
22 back and get improved terms --“ as opposed to the terms that had by that stage already been
23 agreed with British Gas.

24 At para. 353 on p.278 we explain what was going on. Mr. Cook was concerned with
25 persuading his colleagues to seize a window of opportunity to try to achieve a revision of
26 aspects of the deal. It explains what he was doing at that time. At para. 354 we see that
27 National Grid did not go back on any of those principal elements. At paras. 355, 356 and
28 357 we see that what happened after that is that there was a further dispute between
29 National Grid and British Gas about who bears some cost. It was split down the middle and
30 we drew the conclusion from that that showed that even at that stage the bargaining power
31 remained broadly even.

32 THE CHAIRMAN: that was to do with the business rates on ----

33 MR. TURNER: Yes, that is right. The basic point is this: In terms of the structural issues to
34 which I have referred, there are some cost disadvantages; the outside option of the default

1 contracts, and those factors -- Ofgem's only answer, which is, "Well, you could not rely on
2 these terms remaining" was a bad point. In terms of the evidence of the negotiations to try
3 to get a more subjective feel for where the balance of power lies, Ofgem's approach is
4 inadequate and fails to take into account the overwhelming evidence. So, we say that on
5 countervailing buyer power as well the evidence as a whole should tell you that this is not a
6 case where National Grid was dominant.

7 Madam Chairman, I am very grateful for your indulgence. Those are the submissions in
8 relation to that part of the case.

9 THE CHAIRMAN: Do you think that we need to start at ten in order for you to finish by lunch-
10 time?

11 MR. TURNER: I am afraid that the answer to that is 'Yes'. I am conscious that the issues on
12 abuse - which I will attempt to condense to the bare minimum for your purposes are really
13 quite intricate. It may be that questions arise.

14 THE CHAIRMAN: Does that present an overwhelming difficulty for any other counsel? (After
15 a pause): No. Thank you very much, Mr. Turner. We will resume tomorrow morning at
16 ten o'clock.

17
18 (Adjourned until 10.00 a.m. on Friday, 16th January, 2009)
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