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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1099/1/2/08

Victoria House,
Bloomsbury Place,
London WC1A 2EB

16th 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 2)

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 Ms Sarah Abram (instructed by United Utilities Group plc) appeared on behalf of Meter Fit.

1 THE CHAIRMAN: Yes, Mr. Turner.

2 MR. TURNER: Madam, I am grateful. Before kicking off today we have prepared, in order to
3 speed things up, four brief notes which I hope the Tribunal will have had made available. I
4 will briefly say what those are. First, in place of making oral submissions on this matter,
5 there is a note entitled “Effects on CMOs”. That is responsive to the part of the Decision
6 finding an actual foreclosing effect on competition because of effects on the CMOs in the
7 market at the time. It will enable me to deal much more quickly with this orally, to the
8 extent that it is a relevant issue at all. That is that note and I say no more about that for the
9 moment.

10 The second, similarly, is a note entitled “Note of Smart Metering and the MSAs”. Again,
11 you will recall that one of the alleged effects of these agreements is that they impaired the
12 introduction of new technology, and that is what that note deals with.

13 The two remaining notes, which are a single sheet of paper, are responsive to points that
14 arose in questions yesterday. Taking them in turn, the first is entitled “Note: National
15 Grid’s position on sale of its installed meters”. This is our current response to Professor
16 Stoneman’s questions to clarify whether National Grid had refused to sell any of the
17 installed meter stock. Very briefly, the position you will see from this is that it was not
18 ruled out. At para.5 we refer to an internal strategy paper talking about then developing
19 proposals for selling meters when National Grid was confronted with the problem of the
20 stranding risk and deciding what would be its best option to pursue. It then refers further in
21 the note to certain practical difficulties that were perceived to arise, such as at para.8,
22 uncertainty as to the lawfulness of continuing to use the imperial meters, if those were sold.
23 We do not believe that active discussions were entered into with other parties subsequent to
24 that. We have not finally been able to check, unfortunately, overnight the precise position,
25 but we believe, as I said yesterday, the position was it was expected for these reasons that
26 National Grid would get little value from a sale of these assets, and attention moved over to
27 the developing plan to develop these Legacy MSA agreements, the so called “Project
28 JAM”.

29 The final note is a note relating to an issue that arose yesterday about bargaining and market
30 definition. In the discussion that arose yesterday the question was raised about whether we
31 are saying, very crudely, that a new and replacement meter somehow turns into a product in
32 a different market, a legacy meter, the moment that you put it on the wall. I just need to
33 ensure that I have got across our essential point. I am not going to go through this short
34 note now, but I would invite you to read it, and the other parties, to avoid any

1 misunderstanding. Our essential point in response to that is one about the timing of
2 negotiations when you are negotiating for continued provision of meters and what that
3 means for your bargaining power. If you come to negotiate to provide meters to customers
4 before any meters are on the wall, at that stage, and before you have sunk any costs, you
5 are, in our submission, in a much stronger position bargaining wise than if you have to try
6 to negotiate terms only afterwards, after the meter has been placed on the wall and the costs
7 of installing it have been sunk.

8 Our point is that the conditions of competition and the competitive constraints that you are
9 under when you are bargaining in that latter position are different. You are in a more
10 exposed position because you are trying to negotiate when you have sunk the costs and you
11 can be held to ransom. That is why one reason why our case is that table 4 in the Decision
12 which reports these very high market shares is misleading.

13 I must just emphasise that our much bigger point about all of this is that even if you declare
14 that National Grid had a 100 per cent market share because it owns all of these Legacy
15 meters, this is not the sort of case where you can infer from that, as Ofgem does, that
16 National Grid has market power. In many cases, as you know, where you find a firm that
17 has very high market shares is valuable because it indicates that that firm is likely to be able
18 to increase its prices profitably without sufficient competitive constraints. In the
19 circumstances of our case, National Grid says that this very high market share of the
20 installed base does not mean that National Grid was able to raise its prices in that way.
21 Very briefly, it could not increase the prices of the installed meters to anti-competitive
22 levels because there are the price caps which apply. It could not force gas suppliers to deal
23 on unfair terms because they have regulated P&M terms there.

24 Thirdly, and coming back to this market definition issue, National Grid had to bargain from
25 a position where it had already made these customer specific investments in the meters. So
26 the installed base was highly exposed to being ripped out without compensation as fast as
27 was feasible in the circumstances. Our main point is to just draw attention to the difference
28 between that situation and the situation where people in advance, as in a tendering situation,
29 are bargaining with the gas suppliers for new and replacement meters, which has a different
30 dynamic.

31 It is set out in the note and I do not want to take any more time up now about that.

32 Those are the notes.

33 THE CHAIRMAN: Just on the smart metering point – I am not sure whether this is going to turn
34 out to be what has happened, but if it was the case that at the time that the decision was

1 taken it looked very unlikely that smart metering would happen in the foreseeable future,
2 but it has since become apparent that it is more likely to be relevant over the next few years
3 than was thought, what is the position of the Tribunal as regards taking into account those
4 subsequent developments in our jurisdiction to consider the appeal against the Decision?

5 MR. TURNER: Can I answer that in two ways, first, as a matter of principle, and second as a
6 matter of fact. As a matter of principle, we say the gas suppliers were entitled to make the
7 contracts that they did and take the decisions that they did at that time, and that is the
8 relevant point in time for you to look at when you are assessing this risk. Perhaps I went
9 over the board papers rather quickly, but the gas suppliers each did think to themselves,
10 “Well, in a realistic timeframe, imagine if new technology could be brought in, what would
11 that do to costs?” Now, they did not know exactly, obviously, but what they did do was that
12 they assessed the range of sensitivities and they made some quite strong assumptions, and
13 then they compared that against what was on offer. We say that that was a competitive
14 process, and the fact that a little bit further down the line you might suddenly find that
15 unexpectedly a new product shows up does not alter the lawfulness and the competitive
16 nature of the deal that was originally done, in the same way as if I make an arrangement for
17 a mobile ‘phone on a particular contract, and then suddenly I see that although I am bound
18 to my contract, something better unexpectedly appears, I still have to comply with the
19 payment completion arrangements in my own contract. That is the point of principle.
20 The point of fact - and it is partly covered by this note - is that nothing has happened to
21 upset this analysis at all. There is a reference at the back of the agreed statement of facts to
22 one development which is a little company called Utilitas, which is marketing something
23 that is a smart meter, under particular conditions. It is marketing that to prepayment
24 customers only in a particular region of the country, subject to a cancellation charge of
25 about £150 if the customer does not want it any more. It is under those sorts of
26 arrangements.

27 That is very far away from Ofgem’s idea in the decision, which is that what National Grid
28 did was to block a programme where gas suppliers would replace older meters as they
29 became free to replace -- or very cheap to replace with smart meters because no-one ever
30 thought that that would be the way that things would be done. Therefore, the gas suppliers’
31 assessments were bang on then, and remain absolutely accurate now.

32 I am going to tackle abuse. There are two points, just before I get there, which are important
33 to cover and which are both relevant to the central issues of foreclosure in the case. The
34 first is - and I believe I did not cover this sufficiently yesterday - the implications of that

1 review of the gas suppliers' board papers. It struck me from one of the questions yesterday
2 that I need to make this clear. The case against National Grid has been put as follows.
3 National Grid did not compete in response to the new competition. It should have dropped
4 its prices. That would have been competitive. Instead, National Grid reacted by trying to
5 protect itself against the need to compete by negotiating these Legacy MSA contracts which
6 included an objectionable structure of exit charges. By doing that it is said that gas
7 suppliers and their consumers have been denied the fruits of competition - lower prices,
8 improved customer service and the new technology. That is very crude, but I hope not an
9 entirely inaccurate summary of the case against us. What the gas supplier documents
10 illustrate is that that is fundamentally misconceived because the major gas suppliers all
11 considered in those board papers -- They are thinking to themselves, "What are the
12 magnitude of benefits that we can derive from arranging for CMOs to carry out an
13 accelerated replacement programme of these installed meters at much lower prices?" The
14 fruits of competition.

15 They have used sophisticated financial appraisals. They look at a range of sensitivities.
16 National Grid, as those papers demonstrate, had to compete against those benefits. It had to
17 beat them in what it gave to customers. You will recall, for example, in I think the first of
18 those papers, the British Gas board paper saying that the cost savings from the reduced
19 rentals which it would get under the Legacy deals were equivalent to a complete wholesale
20 replacement of the entire Legacy stock in under seven years. British Gas then compares
21 that with what it could hope to achieve through, if you like, that other vision of competition
22 - the accelerated replacement. We had to beat that.

23 If you have the BP bundle and go back to the BG board paper at Tab, p.18 -- This is a paper
24 by their Chief Executive, Mr. Mark Clare. In the second paragraph under the heading
25 'Proposal' the Chief Executive says,

26 "The contract will provide significant benefits in the early years when most of the
27 meter stock is with Transco. Savings for the first full year are £X and the contract
28 provides an NPV equivalent to an accelerated meter replacement programme of
29 less than seven years. A seven-year replacement programme is not considered to
30 be a realistic alternative option, given the impact that this would have on
31 customers and operations. Ofgem are also likely to oppose it".

32 A little bit further down, in the third paragraph,

33 "The attached chart shows the benefit of the proposed legacy deal compared to (a)
34 a normal replacement programme, and (b) an accelerated programme replacing

1 Transco's meter stock over an eight year period (which we believe is the most
2 aggressive exchange programme that could be delivered)."

3 I think that the chart in question you will find in the next tab at p.29. There is certainly a
4 chart which does that. My copy is not perfectly distinct. You see the picture from this. It is
5 entitled 'Meter Provision Costs to British Gas'. What you have in the thick black line at the
6 top is the regulated P&M prices. Then there is a dotted line - normal replacement
7 programme. Then a white line with triangles - accelerated replacement programmes. There
8 you see them looking at the savings they get under the accelerated basis. At the bottom,
9 very faintly, but much lower there, proposed Legacy deal. So, you see the sort of
10 assessment that the company there is making for itself about the respective benefits of the
11 Legacy deal and what I will call, if you like, 'the fruits of competition'.

12 This is why we say the negotiation was not a block, but it was an act of competition. It is
13 why the Legacy agreements are the outcome of competition. These contracts delivered
14 themselves the fruits of competition to customers and consumers. That is my first point. I
15 think that is fundamental.

16 The second observation arising from the same thing is this: these gas supplier assessments
17 are also relevant now to Ofgem's new argument that you should assess foreclosure (which
18 we are coming to) on the basis of what they call the 'no PRC counterfactual'. That is
19 because the gas suppliers compared the Legacy MSA deal against a 'no PRC
20 counterfactual'. In every case, apart from the case of EDF who preferred to stay on the
21 regulated terms, the gas suppliers conclude that the Legacy deal is better for them and better
22 for their customers, and does not exclude competition and does not impair realistically new
23 technology. That is the first area I wanted to cover.

24 THE CHAIRMAN: The Board minutes are dated November 2002, but it was some time later that
25 the legacy agreements were actually concluded?

26 MR. TURNER: Yes.

27 THE CHAIRMAN: But are you saying there is no subsequent updating of this exercise?

28 MR. TURNER: I am not saying that because the Board papers cover a range of dates, you have
29 seen some of them dated 2003, some of them 2004, the picture remains exactly the same.
30 As a matter of fact, in that particular case I think that there is an updated table a little bit
31 later on in the process, but giving the same sort of message at p.33. Here you have a later
32 version, it seems of the same sort of thing. The main differences are that we have additional
33 lines to reflect certain developments, but I do not believe that even this was the final
34 outcome. What you see, for example, in the faint grey line is something entitled "Previous

1 proposed legacy deal” – it is hard to make out – but underneath that you then have
2 something: “New proposed legacy deal” which is even lower. Now, that may reflect the
3 fact that, as Mr. Avery points out, in the course of the negotiations the price came down.
4 Then, as you know, there was this issue about business rates and the bottom line in the table
5 with the black circle is entitled “New proposed legacy deal” including rates. You see that
6 that comes up and is higher, but after that – as you also know – there was then a further deal
7 done in which British Gas and National Grid split the difference, and I do not think that that
8 final line is therefore reflected on this graph.

9 The essential point is that that is the way it was approached. That is how we see you should
10 approach the issue.

11 PROFESSOR STONEMAN: Can I just ask you something about this figure “provision cost to
12 British Gas”?

13 MR. TURNER: Yes, is that on p.29?

14 PROFESSOR STONEMAN: The one you took us to, 29. You have the P&M line, now is the
15 normal replacement programme, the accelerated replacement programme, are those
16 numbers based upon British Gas having P&M contracts? What happens to those two lines
17 if British Gas are on the proposed legacy deal with the PRCs? What have we got here?

18 MR. TURNER: Absolutely. I believe that what you have said is correct, they were thinking to
19 themselves if we enter into the legacy deal, forget the P&M terms that is the line marked
20 “Proposed legacy deal” which runs at the bottom of the figure, showing the lower costs.
21 The other lines represent accelerated, or a normal, a slower replacement pattern under
22 conditions where you are still on the P&M terms, but you engage your CMOs to carry out
23 replacement, and you make savings because they put in meters which are cheaper than the
24 meters that are there at the time.

25 PROFESSOR STONEMAN: Yes, what I am trying to get at is whether there is a middle route
26 here that would involve being on the legacy deal and actually claim the PRCs by taking on
27 the CMOs? Or put it another way around the bottom line – is it assumed in the bottom line
28 that everybody has these meters for 18 years and pays no PRC?

29 MR. TURNER: I am with you. Under the Legacy MSAs, as you know, there is the freedom for
30 the gas supplies to engage CMOs, and a number of them, I cannot remember whether
31 British Gas here is one of them, says to themselves: “We can take the legacy deal and we
32 can also get CMOs to replace meters and put in cheaper meters, and get savings that way as
33 well”. Whether that happens to be factored into this line or not, that effect, I am afraid I
34 cannot tell you. What I can say is that even if it does that might explain that they have fully

1 taken that into account and it helps to explain why it is so low. Even if it does not it is still
2 far lower than the costs of proceeding in the other way.

3 PROFESSOR STONEMAN: Yes, but that must mean that these four lines here are costs for
4 different age mix bundles of meters, so you are not comparing like with like, especially
5 when you get to the end. If you have different age mix bundles of meters here, when you
6 get to the end you have an inherited stock of a different set of ages, and therefore you
7 cannot compare them.

8 MR. TURNER: Well I believe that you can and the gas suppliers all approached it in the same
9 way and from their point of view they are approaching it entirely rationally and sensibly
10 and, indeed reflecting what, from their point of view are the real economic savings to be
11 made because they are interested in the across the board picture that comes out of all of this
12 and under the legacy MSA deal you envisage the entire stock progressively being replaced
13 over the period at the free rate, and you can put in cheaper meters as you go. The actual
14 ages of the stock does not really come into that because that is not how the Legacy MSA
15 works. Similarly, under the P&M contracts if you stay on that you can replace on whatever
16 basis you like, but you only need to replace (and you only do replace) the policy meters
17 which are not necessarily the old ones at all and the customer requested exchanges for your
18 own reasons as well, so again there is no necessary relationship between the replacement
19 pattern and the age of the stock.

20 PROFESSOR STONEMAN: Let us take then the accelerated or normal replacement
21 programmes, so this is where you are buying your meters from CMOs and most of the
22 CMOs are giving out contracts – is it a five year PRC? They have a five year length after
23 which you pay a PRC – you have to pay a PRC ----

24 MR. TURNER: It is 20 years.

25 PROFESSOR STONEMAN: The CMOs is all 20 years, is it?

26 MR. TURNER: Yes, it is.

27 PROFESSOR STONEMAN: Ah, then I am mistaken.

28 MR. TURNER: My friends are probably going to take you to what those arrangements are but I
29 can tell you right now it is a 20 year “lock-in” if you like, if I can use that term without
30 being emotive, but the position is that there is a primary period and a secondary period, and
31 the point is that they are, under their contracts, the exclusive meter providers for British Gas
32 for that primary period, but the meters themselves have protection all the way.

33 PROFESSOR STONEMAN: Then the point becomes less relevant.

1 MR. TURNER: Okay. We can no doubt return to this, we will have a witness from British Gas
2 here.

3 Only one other point relating to competitive entry and foreclosure before I dive into this.
4 When you read the Decision, when anyone picks up that Decision and reads it cold you get
5 the impression that the Legacy MSAs have substantially or completely blocked the market
6 to CMOs just as it was open to competition. So we will need CB1. If you go in it, for
7 example, to para.4.166, p.108 of the external numbering. What Ofgem is doing in this
8 paragraph is responding to the point National Grid makes that actually you can replace large
9 numbers of meters under the Legacy MSAs and the response of Ofgem as you will see from
10 the end of this paragraph is:

11 “In particular, the effect of the Legacy MSAs to inhibit suppliers from switching
12 meters in the short and medium term, when competition with NG is nascent. The
13 fact that it is possible for suppliers bound by the Legacy MSA to have switched a
14 substantial number of meters by the end of 15 or 20 years is insufficient if by that
15 stage competition has been stifled through earlier market foreclosure.”

16 They put it quite strongly there, and at various points in the Decision, not there, they talk
17 about preventing switching to CMOs. That expression – you find it, for example, in 4.1
18 right at the beginning of the abuse section – is not just emotive, it is inaccurate, because the
19 Legacy MSAs do not prevent switching to CMOs. What they do is discourage or
20 disincentivise the gas suppliers from engaging their CMOs, using the CMOs they have
21 engaged, to replace more meters than the level envisaged by the glide path, as opposed to
22 engaging them in the first place, switching to CMOs. It is a different thing. It is only about
23 the volume of meters above a certain level, but not about the question whether you actually
24 engage CMOs at all.

25 THE CHAIRMAN: It is a disincentive to replace the meter, whether to do so with a new National
26 Grid meter or a new CMO meter.

27 MR. TURNER: That is right.

28 THE CHAIRMAN: The gas suppliers who have not engaged a CMO, they still risk going into the
29 Take or Pay zone or incurring PRCs if they get National Grid to replace more than the free
30 allowance of meters, even though one might have thought that it is in National Grid’s
31 interests for everyone to be churning their meters. I do not mean “churn” in the sense it is
32 used here, but because it is more business for you, I suppose.

33 MR. TURNER: Whether you have a CMO contract or not, and it is easiest to think of British Gas
34 which has the CMO arrangements, the point is that it is not disincentivising its gas suppliers

1 engaging CMOs, switching to CMOs, it is word play in a sense. You are absolutely right,
2 what it does do is disincentivise the gas suppliers, because of the charge, from replacing
3 more than a certain number of meters. I think it is important to get that straight when you
4 are talking about foreclosure, particular because, as I mentioned yesterday, the Decision
5 does not report the very rapid and substantial progress that has been made by British Gas's
6 CMOs in the market, which is set out in our notice of appeal.

7 PROFESSOR STONEMAN: So you say it does not disincentivise CMOs from talking to British
8 Gas?

9 MR. TURNER: Being engaged by British Gas.

10 PROFESSOR STONEMAN: Being engaged by British Gas. Might it not, because of the smaller
11 size of the market, disincentivise people from setting up as CMOs, limiting entry to the
12 market because the market is smaller than it might otherwise have been?

13 MR. TURNER: We have no evidence or investigation which supports that sort of proposition.
14 There is a suggestion in the Decision, you are right, that this is a market where there are
15 economies of scale, and so forth. If there is much more to go at it could be cheaper and you
16 might be able to offer cheaper products.

17 As a very, very general level of principle, you might say that that is something that is
18 worthy of investigation, but it is not something that is investigated in this case and there is
19 not any actual evidence that people have ever thought to themselves, this makes it
20 unprofitable for CMOs to be engaged. You will hear the contrary case. Naturally you will
21 hear all sorts of grumbling as this goes on, but that is ----

22 THE CHAIRMAN: I know what this grumbling is about and they are right in a way. Yes, the
23 point is that it is a smaller ----

24 MR. VAJDA: Madam, it is a pleasure when one's point is made just by grumbling!

25 THE CHAIRMAN: What is striking about all these board papers that you showed us is that
26 nobody seems to say, "Well, we ought to sponsor this new entry by engaging the CMOs so
27 that they continue to be there to exert a competitive pressure on National Grid". That does
28 not seem to enter into it.

29 MR. TURNER: What they do say, and I can find the references, in some cases is, what about
30 competition, and they note to themselves that the contracts allow the scope to bring on
31 CMOs if they want to, and that would bring additional benefits. They all essentially take
32 that for granted.

33 So then you get a question, if you were really going to investigate this seriously you would
34 want to know, is the issue with economies of scale such that these contracts are really

1 closing things off for people? Not only has that not been investigated, you have got the
2 evidence that it is not the case by the facts on the ground.

3 THE CHAIRMAN: We understand the point you are making and I am sure other people will
4 have things to say about that.

5 MR. TURNER: Yes. I am reminded that I did not point this out yesterday, that there have been
6 also certain further developments in the market. We talked yesterday about the stalling of
7 tenders. You may not have picked up, if you have got CB2 there, tab 20, I think it is the last
8 page in the whole bundle, the market development since the Authority's Decision. For
9 completeness, you will see that with two of the major gas suppliers there have been certain
10 further developments. Eon gave a formal notice of election under its MSA agreement that it
11 wanted to carry out non-NG provision itself in certain respects. SSE has issued an election
12 notice to appoint two commercial meter operators as from April 2009, OnStream and Scotia
13 Gas networks, and that is against the background of the MSAs.

14 Mr. Holmes reminds me, of course, that in-house provision by these people is just as much
15 competition as the CMO arranging for competition with National Grid metering as well.

16 THE CHAIRMAN: That was not included in that table you showed us yesterday.

17 MR. TURNER: That table in para.263 of the notice of appeal precedes these developments.

18 THE CHAIRMAN: What about in-house supply?

19 MR. TURNER: These two developments here are since that table.

20 THE CHAIRMAN: I understand.

21 PROFESSOR STONEMAN: You did tell us that nobody wanted to in-house supply because of
22 the cost of owning meters is an unnecessary risk. Does that mean that situation has changed
23 now?

24 MR. TURNER: I do not know further details about how this is being arranged than is presented
25 here, I am afraid, sir. We might be able to find out.

26 The final point which has been put at me before I get on to abuse – give you some abuse! –
27 is that Mr. Avery, and I will give you the reference at para.25 of his statement, when he is
28 talking about British Gas's thinking when it decided to enter into the legacy agreements,
29 and he said that they saw benefits in keeping three players in the market. They took the
30 view at that time that that would be a healthy thing to do, and they said that the Legacy
31 MSAs allowed them to do that.

32 Finally then, abuse: I would ask you to go to p.65 in the Decision. What I would like to do
33 in a few minutes is just establish, because of its importance given the development of the
34 argument, what is the structure, what is the logic of Ofgem's Decision. It is a decision

1 about abuse by means of foreclose of effective competition. As I said yesterday, Ofgem
2 accepts in this case that competing for contracts with cancellation charges is consistent with
3 normal competition in this industry. That is the way the competition can happen. It is not
4 restrictive.

5 I referred to the defence. I think perhaps it may be a good idea also just to show you what
6 their expert said from an economist's point of view. If you would take WS4 and go in it to
7 big Tab 9, you have there the witness statement of Professor Paul Grout. On p.2138 at
8 paras. 20 and 21

9 "This raises the question of what features a rental contract might have in normal
10 competition.

11 I note first that it is a standard feature of many rental contracts for durable goods
12 that they last for a specified minimum period, and that the customer has to pay
13 some sort of termination fee in order to exit before the end of that period. The
14 combination of the minimum rental period and the termination fee gives a degree
15 of protection to the owner, who is otherwise exposed to the risk that part of his
16 investment will be lost if the buyer chooses to rent from a different seller. This is
17 particularly important where the owner incurs costs up-front which will be lost if
18 the customer terminates the rental contract. This is clear in the case of DCMs, in
19 respect of which the majority of the cost is installation costs and the meter itself
20 has little or no re-use value".

21 That is Ofgem's expert talking about what is normal.

22 MR. VAJDA: If you could go back to para. 8 of Professor Grout's statement -----

23 THE CHAIRMAN: I think Mr. Turner should make progress on his submissions.

24 MR. TURNER: I am grateful. I do not mind grumbling, but otherwise I might not get through it.

25 MR. VAJDA: I am not asking the Tribunal to take up time. I am just drawing it to the Tribunal's
26 attention.

27 MR. TURNER: So, returning then to the Decision, working on the basis of what Professor Grout
28 says, and Ofgem accepts, if the Legacy MSA is a competitively-priced deal for renting a
29 portfolio of these meters, and on the basis that its cancellation charges, by design, achieve
30 payment completion -- They have been organised so that National Grid is simply no worse
31 off if you do take the meters out earlier than committed to, what here is the problem? What
32 is the source of the anti-competitive foreclosure in this case?

33 Paragraph 4.4 in the Decision tells us that it is not the MSAs in toto - it is two specific
34 features of the Legacy MSA. (a) is the early replacement charging arrangements and the

1 structure of them, which is the Take or Pay arrangements and the PRC arrangements. (b) is
2 the bundling of meter maintenance. By the way, I may as well say here in relation to the
3 PRC arrangements that you know that the Decision consistently talks about the PRC
4 arrangements as average arrangements. In fact, flat rate is the far more accurate term than
5 average because you do not arrive at these PRCs by looking at the actual ages of the meter
6 stock in any way and then taking an average figure - for example, based on an assumption
7 that they are free to replace after, say, twenty years. The mechanism is described in the
8 agreed -- this part is not agreed -- in the Statement of Facts at paras. 145 and 148. If you
9 would just perhaps open CB2, Tab 20, para. 145 (which begins at p.56 of the manuscript
10 numbering) -- I am not going to go through this detail now, but essentially if you skip to
11 para. 148 what is said is, "Contrary to Ofgem's apparent belief, this approach does not start
12 by taking PRC values for different ages of meters within the portfolio, and then 'averaging'
13 across them. It proceeds on the basis that, under the agreed glidepath, there are equal
14 numbers of meters removed in each remaining rental period over the contract term, and
15 therefore also equal numbers of meters corresponding to each remaining rental period (in
16 months). The PRCs set for each year are most aptly characterised as the 'payment
17 completion' values for the relevant year, and **not** as an average of values for meters of
18 different age".

19 In other words, if you like, rather than actual ages of these meters, what this assumes is
20 contracted ages - and even that is a slightly misleading way of putting it - and that an equal
21 number of meters is taken out every rental period over the full-term of the contract.

22 Paragraph (b) refers to the bundling of meter maintenance. I comment only that here it is
23 said to add appreciably to the foreclosing effects of the first feature - the early replacement
24 charges. Later on, as I said yesterday, and in the operative part of the Decision, this second
25 feature is not considered to have an impact serious enough to be classified as objectionable
26 by itself.

27 Paragraphs 4.6 to 4.34 are all about the legal test for abuse, including what is meant by the
28 term 'foreclosure' in competition law. I will come back to that. There is then a short section
29 on context. Ofgem then analyses foreclosure in a very long section, extending from 4.43 to
30 4.127. That is the entire section. The content is very important because it shows the
31 integral nature of the comparison of the age basis and the PRCs, which is what Ofgem says
32 can be taken as a benchmark - a useful counterfactual - for its assessment of foreclosure.
33 Beginning at 4.86 you get the extended discussion of the relevant counterfactual which is
34 supported by a number of annexes at the end of the Decision. At the end of that - at 4.98,

1 4.99 and down to 4.101 - Ofgem finds that an age-based approach to PRCs would have
2 given more scope for meter replacement to competitors than the structure which was used
3 by National Grid. His comparison involves a number of steps: (1) Ofgem starts by
4 assuming that it is realistic to think of the gas suppliers wanting to replace about half a
5 million more credit meters, each of the first three years of the contract than the MSA free
6 allowance of 980,000. That is 4.72 and 4.73 of the Decision. If you look at 4.73 (because I
7 will return to that), that is said to be reasonable (to use the language of the Decision) in
8 relation to the actual levels of replacement that BGT had contracted for ahead of its signing
9 of the Legacy MSAs. After the first three years Ofgem assumes that the level of the
10 replacements is cut back to what gas suppliers would expect to be the minimum number that
11 they have to engage in to root out inaccurate and faulty meters and to carry out customer-
12 requested exchanges.

13 The next thing Ofgem does is to work out what such a level of replacement of these
14 additional meters would cost under the Legacy MSAs cold. That is paras. 4.74 to 4.78.
15 The third thing is that Ofgem applies that same replacement scenario - I am assuming
16 500,000 more meters a year for the first three years - to its aged-based counterfactual, under
17 which all of the policy meters regarded as free to replace, any meter over 20 years old is
18 free to replace, and you have a system of progressively increased charges for meters in
19 between, for the younger meters, that is 4.86 to 4.98.

20 Now, what about the values for the age related PRCs, which Ofgem uses as its inputs?
21 Ofgem says at 4.97, on p.89 of the external numbering:

22 “These age-related PRCs are derived directly from NG’s calculations of the
23 averaged PRC level for 2004, although with an adjustment having been made to
24 NG’s avoidable cost assumptions to bring them in line with a more reasonable
25 assessment of avoided costs.”

26 If you see footnote 310 as well along the same lines at the bottom:

27 “ Again, this figure is calculated so as to achieve the same revenue as the MSA
28 PRCs over the life of the meter.”

29 What Ofgem then finds when it applies these charges and that structure to its replacement
30 scenario is that the charges would be much lower for additional replacements, and that is
31 4.98 and 4.101. Its conclusion therefore is that the Legacy MSAs are more restrictive than
32 this benchmark.

33 Then, beginning at 4.102 Ofgem turns from looking at the process, identifying the presence
34 of the restriction to its practical effects, and it considers the impact of the foreclosing

1 activity it has found on competitors, customers and consumers, and the number of chunks.
2 The grand conclusion is 4.127 on p.98 where Ofgem says:

3 “For all of these reasons, the MSAs have the actual and likely effect of foreclosing
4 competition within the relevant market.”

5 Note here that it does refer to the problem as being that gas suppliers cannot switch to
6 CMOs without incurring artificially high switching costs. As I said yesterday in opening
7 remarks, this reference to the switching costs, or the associated economic incentives on the
8 gas suppliers being objectionable because they are artificial is a repeated theme in the
9 decision and with that you turn to the law. What is the test for abusive foreclosure? 4.6 in
10 the Decision starts by referring to the classic case of *Hoffmann La Roche*. That case refers
11 in the definition to “recourse to methods different from those which condition normal
12 competition”.

13 Pausing there, it may not be possible, as in this case we accept, to identify, if you like, a
14 normal way of doing business based on past experience in competitive metering, because
15 there has not been much, but you still have to have a benchmark for assessing whether some
16 specified conduct is hindering effective competition. That is rightly taken for granted by
17 Ofgem in the Decision. If you look at the facing page, 4.11, first sentence:

18 “The CAT regards the relevant counterfactual to be a question of fact to be
19 decided by reference to various interrelated facts and considerations.”

20 So Ofgem correctly assumes here that the analysis of foreclosure does involve measuring
21 this conduct against some counterfactual and it goes on to attempt to do that.

22 4.14 then gives a definition of the term “foreclosure” based on the European Commission’s
23 Staff discussion paper of December 2005. That has been superseded and we now have the
24 Commission’s published guidance from December 2008, and may I ask you to turn back to
25 A6, tab 20. Paragraph 19 on p.8 sits under the heading: “Foreclosure leading to consumer
26 harm (“anticompetitive foreclosure”):

27 “The aim of the Commission’s enforcement activity in relation to exclusionary
28 conduct is to ensure that dominant undertakings do not impair effective
29 competition by foreclosing their rivals in an anticompetitive way and thus having
30 an adverse impact on consumer welfare, whether in the form of higher price levels
31 than would have otherwise prevailed or in some other form such as limiting
32 quality or reducing consumer choice. In this document the term “anticompetitive
33 foreclosure” is used to describe a situation where effective access of actual or
34 potential competitors to supplies or markets is hampered or eliminated as a result

1 of the conduct of the dominant undertaking whereby the dominant undertaking is
2 likely to be in a position to profitably increase prices to the detriment of
3 consumers.”

4 Paragraph 20, which refers to the way the Commission approaches its work, says:

5 “The Commission will normally intervene under Article 82 where, on the basis of
6 cogent and convincing evidence, the allegedly abusive conduct is likely to lead to
7 anti-competitive foreclosure.”

8 and it then goes into the factors it will generally take into account. What is of interest over
9 the page in the last section above para.21 is that the Tribunal says half way into that:

10 “This assessment will usually be made by comparing the actual or likely future
11 situation in the relevant market (with the dominant undertaking’s conduct in
12 place) with an appropriate counterfactual, such as the simple absence of the
13 conduct in question or with another realistic alternative scenario having regard to
14 established business practice.”

15 That is the Commission’s guidance. The crucial point is this: the need for a benchmark in
16 an Article 82 foreclosure case is absolutely clear for any serious analysis. For example, take
17 predatory pricing, to show predatory pricing where you cross the line it is not enough to
18 point to low pricing by a dominant firm and say that that has hindered entry, which it might
19 well have done, and higher pricing in the short term by the dominant firm would have led to
20 more new entry which, in turn would have had all the benefits of greater dynamic
21 competition and so on and so forth. Then you can assume consumer gains in the long run.
22 The law establishes that anti-competitive foreclosure happens when there is pricing below
23 some objective cost benchmark, not just pricing below some entrant-friendly higher prices.
24 I say that while asking you to cast your minds back to the nature of some of the complaints
25 you saw from the industry about National Grid’s agreements when they were announced.
26 In this very case Ofgem says that National Grid could perfectly normally and lawfully have
27 dropped its rental prices for installed meters without any payment completion protection to
28 meet competition from new entrants, it says “There you are that is normal competition”.
29 Consider this, if National Grid had dropped its prices of these installed assets, all their sunk
30 costs, it would have killed off any competition from new entrants, resulted in no competitive
31 market structure at all. National Grid then keeps a higher market share than it has done
32 under the MSAs, possibly a monopoly and with the prospect of increasing its rentals again
33 once the CMOs have given up.

1 What happened in the lay sense is total foreclosure. Ofgem says in its skeleton at para.99,
2 “this would have been welcome” – welcome, because it would have reflected normal
3 competition. It would not have been anti-competitive foreclosure. Our reaction to that is,
4 that is a nonsense, that would be the destruction of the project of competitive metering
5 altogether through this low pricing. That would have been, by any reasonable light,
6 foreclosure. That would have been exactly what the industry had been complaining about in
7 the early stages before this investigation was getting going, their fear. Yet Ofgem says that
8 is welcome foreclosure. This points up the need for Ofgem to apply some benchmark
9 against which to measure the supposedly objectionable charging structure in the Legacy
10 MSAs as being anti-competitive foreclosure.

11 Our key proposition is this: that ultimately in a case where, like this, the allegation is that
12 the particular structure of charges, the payment completion charges, is what is causing anti-
13 competitive foreclosure. You need to establish what extent of replacement you would
14 expect to find under some normal competitive conditions, such as, for example, where the
15 meters are simply sold, the assets are simply sold with an up-front payment, and then you
16 ask yourself whether this allegedly abusive conduct is materially blocking that replacement.
17 This point is set out in our skeleton argument at para.31(h).

18 Based on that there are two essential questions for you to resolve, which I hope are reflected
19 in that short hand-out I gave.

20 PROFESSOR STONEMAN: Just before you go on to that, para.31(h), is that the one that comes
21 with the associated mathematical appendix?

22 MR. TURNER: I will check whether that is ----

23 PROFESSOR STONEMAN: In your skeleton. I would like to ask you if any of your expert
24 witnesses are going to talk to that?

25 MR. TURNER: The answer to that question is that is based on a report and the opinion of
26 Dr. Williams, and Dr. Williams can speak to those matters, yes.

27 PROFESSOR STONEMAN: That is all I wanted to know, because I have problems with it.

28 MR. TURNER: Absolutely.

29 As I was saying, you, therefore, in our submission, have two essential questions that you
30 need to resolve. First, looking at the way Ofgem has done this, question number one, is an
31 age base system of charges an appropriate benchmark at all in the circumstances of this
32 case, given what you know about the context and the negotiations in the industry?
33 Question number two, has the comparison with an age base system of charges been
34 meaningfully executed by Ofgem in the Decision or not?

1 I am going to have to speed up a little. The first question, is an age base system of charges
2 an appropriate form of benchmark in the circumstances of this case? In the Decision itself,
3 if you look at 4.89, Ofgem gives its reasons for having used this for its counterfactual. That
4 is at the foot of p.86, and it says:

5 “As they are the contractual form used by CMOs, UMS and NG in the N/R MSAs,
6 age-related PRC arrangements are a useful counterfactual against which to
7 compare the effects of the Legacy MSAs on the development of competition.”

8 It goes on in that paragraph to say that they do not necessarily represent the benchmark for
9 normal competition for reasons which have been given in the supplemental statement of
10 objections concerning National Grid’s dominance.

11 I need just to chase that down. Would you pick up PD2, which has the supplemental
12 statement of objections and turn to tab 31, p.1130 of the external numbering. You have at
13 the foot of that page the paragraph that they are talking about as their reason, 5.9. The
14 reasoning really picks up in the second sentence:

15 “When the CMO contracts were negotiated and agreed the CMO’s contract terms
16 were affected in important respects by the behaviour of NG in negotiating and
17 concluding the MSAs. The Authority therefore thinks it is not correct to assume
18 that other CMO’s practices represent good evidence of a ‘normal’ method of
19 competition in the domestic gas metering market.”

20 That is a mistake. The CMO contracts with British Gas are all in similar form. The
21 Meter Fit contract was actually concluded in May 2002, which is apparent from the time
22 line on p.20 of the Decision, when the Legacy MSA negotiations were only just starting and
23 the Legacy MSAs were a twinkle in the eye. So that qualification by Ofgem falls away.
24 The justification from an economist’s point of view, Ofgem’s economist, for why age base
25 charges you would expect in normal competition to arise for the installed Legacy meters
26 appears in their expert, Professor Grout’s evidence. For reasons of time perhaps we will
27 come back to this, but it is paras.22-26 of his report, WS4, tab 9. What he says in particular
28 is that National Grid could be expected to want to put in place charges that make it more
29 attractive to replace the older assets first because those are going to be less valuable than the
30 younger assets – in other words, you are using the structure of these exit charges as a sort of
31 estate management tool by the meter provider, National Grid.

32 Our case is that what is being overlooked in that economic point of view is all the other
33 legitimate considerations that went into the decision to use these flat rate PRCs that declined
34 progressively every year down to zero. You have seen those in particular from the slide

1 presentation we looked at yesterday. They are summarised in paras.22 and 23 of our reply,
2 which we also looked at earlier. Essentially they include the high transaction costs that
3 were perceived of an age base system and significant numbers of old meters with unknown
4 ages.

5 Pausing there, these high transaction costs, that has to be a salient feature when you are
6 assessing what is an appropriate form of charging. They also refer to there being under the
7 legacy arrangements perceived greater flexibility for meter operators to take out meters in
8 the same area with no charges applying, even though those meters might be of varying ages,
9 because meters together may well not be all of the same age.

10 Lastly, they refer to the fact, which you will see reflected in gas suppliers' and particularly
11 British Gas's papers as well, of stable and predictable volumes of free removals every year
12 achieved by this structure which British Gas in particular said it wanted for its CMOs.

13 On top of that, and still thinking about Professor Grout's rationale, the legacy agreements
14 also do include a means for National Grid to root out the non-valuable meters, the
15 inaccurate policy meters, by steering gas suppliers specifically to replace these out of a wide
16 pool. Policy meters are nominated of course on a big pool on the replacement schedule, and
17 then you have to replace those to keep the stock healthy.

18 At British Gas' request there was also included in the structure the Take or Pay or below-
19 line rental band as a tolerance device so that instead of incurring full whack PRCs, if you
20 happen to go above the glidepath in a particular year you can pay lower amounts based on a
21 yearly rental for those meters. For the record - and we will come to it - Dr. Williams
22 grapples with Professor Grout's economic opinion on normality here in his second report at
23 paras. 120 to 125 (which you will be reading before he gives evidence).

24 My summary: Given the unique circumstances of the negotiation over the terms of
25 continued provision of 20 million installed Legacy meters in one go, there was no
26 compelling practical, and no compelling economic reason, to use a system of age-based
27 PRCs. National Grid's system was hammered out in discussions with the major customer,
28 British Gas in particular, and it was fully responsive to British Gas 'asks'. It was natural. It
29 was unobjectionable.

30 Having said that, is there some other obvious benchmark in this sort of case when you, the
31 Tribunal, are assessing whether National Grid's charges and the Legacy MSAs have crossed
32 over a line and have caused anti-competitive foreclosure? In fact, we say there is such a
33 benchmark and Professor Grout himself pointed it up in his report -- Perhaps on this one if
34 you would pick up Grout again in WS4, Tab 9, p.2135. What he says at para. 10 is,

1 “The most common, and perhaps the most obvious, way of paying for products
2 which share many of the characteristics of meters is sale by way of an upfront
3 payment. This is the standard payment arrangement for comparable items of
4 similar cost, such as radios, and for other items with high installation costs, such
5 as in-built washing machines or dishwashers, even though the cost of purchasing
6 these items is significantly higher than the cost of a DCM or even a PPM”.

7 Then, at para. 13 he says,

8 “In principle, I therefore consider that, following the separation of gas meter and
9 maintenance payments from transportation charges and the opening up of the
10 meter market to competition, it would have been consistent with ‘normal
11 competition’ for National Grid to sell the meters to gas suppliers for a one-off
12 payment”.

13 We entirely agree with that. Selling assets cannot be foreclosing regardless of whether, in
14 economic terms, dis-incentivises you then going forward from taking a slightly cheaper
15 asset in the future.

16 So, we agree with that, but please consider the implications. The replacement incentives
17 that gas suppliers would have had if they bought the meters for a one-off payment would
18 have been consistent with normal competition. So, now we are entering the territory of this
19 annexe. We say that that gives you a clear benchmark. In the case of sale you have
20 committed to pay for the meters with their sunk costs, and you are only going to replace
21 them if the additional benefit of a new meter outweighs all the costs of outlay on the new
22 meter. In the case of a rental under terms where you have got payment completion, you
23 equally commit to pay for the meter if it is replaced early. We say the position is exactly the
24 same. You have not already paid it. You have simply committed to pay it for the future
25 time. You have got the same incentives to replace the installed meter with a new one.
26 So, then, the question is, now coming back to what National Grid did, would you expect
27 National Grid’s charging structure in the Legacy agreements to result in some smaller level
28 of replacement than in that kind of normal situation? We have one significant point to
29 make about that, which is that you would expect the opposite to be the case here because the
30 Legacy MSA glidepath was not just arranged to allow enough replacement to recover the
31 ordinary run of replacements that you would expect every year and to which Ofgem and the
32 MMC limited the Capex allowance in the price control every year.

33 On top of all that, it provides for this substantial amount of freebies - the additional
34 discretionary replacements to cover not just the customer-related exchanges (whatever you

1 want for that), but, as PowerGen said in one of the board papers we looked at yesterday, a
2 whole tranche of fully working good meters on top for free, over and above the natural
3 replacement cycle. Ofgem's estimate in the Decision (which I am happy to go with for
4 present purposes) is of around 130,000 fully functioning credit meters every year on top of
5 CREs.

6 The next question: Does the issue of the Take or Pay or below-line rental band in any way
7 affect that conclusion that the Legacy MSA charging structure is not foreclosing? We say
8 that it does not do so. If you pick up our skeleton I will try to take that as quickly as
9 possible by reference to this. At paras. 73 and 74 of Tab 14 in CB2 -- We think what it
10 boils down to is ultimately two points (p.37 of the skeleton). The first point is that the
11 avoidable costs, which is the issue here, in relation to the credit meters are, in National
12 Grid's own assessment, very small. Ofgem makes a half-hearted attempt to say, "No, you
13 have got those wrong". The respective positions are set down there in writing, and I cannot
14 go into them in detail now. Ultimately, we say it has not got a serious basis for its
15 assertions to the contrary. It was not investigated by them. There is no reason to think that
16 the absence of a deduction for avoidable costs when you are in this BLR band has any
17 material impact on replacement incentives and no industry party has said, "Well, that
18 materially impacts our incentives". By the way, it is, of course, National Grid's position
19 that whether it is PRCs or you are in this band, either way, of course there is a dis-incentive
20 as compared with it being free to replace. That is the first point.

21 The second point is set out at para. 74, particularly (b) and (c). That is to remind the
22 Tribunal that the BLRs are part of an overall package under the Legacy agreements which
23 provides for this generous level of free replacement including the working meters under the
24 glidepath. Because it allows working meters to be replaced free of charge, if anything, you
25 are talking about replacement above the benchmark level. We say that any effect - if there
26 were an avoided costs additional disincentive effect to take into account, that is more than
27 outweighed by this feature of the package which is that it gave such a large amount of
28 replacement entirely for free each year.

29 Now, with the Tribunal's permission I am going to leave there the question of whether
30 Ofgem was tilting at the right counterfactual, the right benchmark at all, and turn to the
31 question, which is also important, of whether they did it right. Was the age-related
32 counterfactual meaningfully executed by them in this Decision? There are two aspects to
33 this: (1) the credibility, the solidity of its replacement scenario, assuming that the gas
34 suppliers would have wanted to replace half a million more meters in aggregate every year

1 for the first three years; (2) the execution of the age-related counterfactual which they then
2 apply to their replacement scenario. The replacement scenario is, as I mentioned a bit
3 earlier referred to at para. 4.73 of the Decision at p.83. Essentially you ask yourself why is
4 Ofgem saying that we should be looking at a situation where the gas suppliers are wanting
5 to replace more than half a million or more meters additional to the glidepath every year for
6 the first three years of the contract, 2004, 2005, 2006, where does that come from? What
7 they say is that these scenarios are reasonable in relation to the **actual** (emphasised) levels
8 of replacement that BGT had contracted for ahead of its signing for the Legacy MSAs. So
9 what they are saying is that before the Legacy MSAs trample over this with their muddy
10 boots that is what British Gas was envisaging its CMOs were going to be doing. This turns
11 out to be a false statement. If you turn to CB2 tab 8 you have National Grid's supplemental
12 submissions when we finally got to the bottom of this and were permitted to put in
13 submissions to address it, at tab 8, p. 741, the relevant paragraphs are 25 to 41. I will ask
14 you to read them for yourselves later. The essential point is this: at para. 27 we set out that
15 extract from the decision, at 28 we say we then discover that these alleged reductions in
16 volumes were not based on information about the actual levels of replacement BGT had
17 contracted for at all, but on certain estimates by Ofgem and nothing else. We go on to say
18 that those estimates were completely flawed, and it is para. 29 that the actual evidence
19 available to Ofgem in fact shows that the reduction in volumes for the two independent
20 CMOs, in Ofgem's eyes the relevant CMOs in relation to the finding of abuse, amounted to
21 a very small number, undermining the proposition that the 50 to 65 per cent is conservative.
22 We then go on in the subsequent paragraphs to address that. The only point I will mention
23 briefly is that if you go over the page to p.16 and look at one of the CMOs, Meterfit, you
24 actually find that the MSAs where Ofgem had assumed the yellow highlighted reduction
25 mentioned in para.36, was completely wrong; based on the information in the file we
26 showed that Meterfit's volumes actually went up year on year and that will be a matter we
27 can go into when my friends speak.

28 MR. RANDOLPH: Yes.

29 MR. TURNER: But you will see in any event that the basis for what Ofgem take for their
30 replacement scenario is, on our case, flawed and wrong.

31 THE CHAIRMAN: But nonetheless we have the evidence of Mr. Lewis and Mr. Neil Williams,
32 and perhaps Mr. Southgate, as to the negotiations over the reduction in volumes.

33 MR. TURNER: Yes.

1 THE CHAIRMAN: And as far as I am aware you are not planning to cross-examine those
2 witnesses?

3 MR. TURNER: Yes.

4 THE CHAIRMAN: So if we are to take the evidence of those witnesses in the absence of cross-
5 examination as accepted by you, your submissions on this volume point need to take that
6 into account.

7 MR. TURNER: I am grateful for that indication. Madam, would you mind giving me the precise
8 references, maybe not now, that you are referring to. I will make only one comment at the
9 moment which is for our part we have the two British Gas people giving evidence for
10 National Grid now, Mr. Avery and Mr. James, who also give evidence on the those
11 particular issues and they are, of course, being cross-examined.

12 THE CHAIRMAN: Yes, but Mr. James was the boss of Mr. Lewis and Mr. Williams, and Mr.
13 Avery was Mr. James's boss as far as I understand it?

14 MR. TURNER: Yes.

15 THE CHAIRMAN: So you have two of the team batting for you, but two of the more junior
16 members of the team are batting for CML?

17 MR. TURNER: Well let us see what they say. I will need to go back to their statements, but –
18 and I will be corrected if I am wrong about this – I do not believe that they say that the
19 Meterfit volumes for a start dropped as a result of the renegotiation.

20 MR. RANDOLPH: They did not, but Paul King does. I am slightly concerned about the fact that
21 Mr. Turner has said as a statement or assertion that volumes actually went up. There is a
22 major debate on that issue. I have noted in passing from one of Mr. Turner's many notes
23 this morning, that this issue is again dealt with as an issue of admissibility, so I do not want
24 the Tribunal to think that this is just a matter that can go forward without more, there is also
25 the point not only that relates to CML but also with regard to Meterfit following on from
26 your question with regard to non-examination of witnesses because of course Mr. King says
27 quite clearly that volumes went down.

28 MR. TURNER: Well we will deal with what Mr. King says in context. That is actually a good
29 example of a case where we have the documents which actually show exactly what has
30 happened, and Mr. King, if anything gives his opinion on the motivations for certain
31 changes that took place.

32 THE CHAIRMAN: Well I do not want to get into this now but I just want to point out the
33 relevance of the evidence. I am very far from suggesting that you should cross-examine

1 more people than you have already said that you want to, but you need to make sure that
2 your submissions are not inconsistent with the stance that you have taken as to the evidence.

3 MR. TURNER: That is a point very well taken, madam, we will check that. I say now, only for
4 the record, that we do not believe that what I have just said, and our position, for example,
5 in relation to Meterfit and, indeed, CML is inconsistent with that evidence, but we will look
6 at that.

7 PROFESSOR STONEMAN: Can I just ask for a point of clarification? It seems to me that the
8 argument you are making is that the introduction of the MSAs did not affect CMO volumes,
9 is that correct?

10 MR. TURNER: We say that they did not lead to a reduction in the volume for Meterfit, these
11 people who are actually there, we say that there is no obvious reason for thinking that they
12 led to a reduction in the volume finally made available to CML. CML had its contract
13 finally struck in December ----

14 PROFESSOR STONEMAN: There is no need for the details, just the main point.

15 MR. TURNER: Okay, that is the point as regards those independent CMOs in the market, but on
16 the more general level of principle I am happy to accept for National Grid that contracts
17 which contain payment completion charges, exit charges as opposed to the P&M style no
18 notice agreements may be expected generally to lead to lower levels of replacement.

19 PROFESSOR STONEMAN: Because it seemed to me in many ways that National Grid did a
20 very bad deal, they gave away lower prices and they did not get any increases in quantity,
21 you are saying, and so you are a great deal worse off than if you had stuck with P&M
22 contracts in the first place.

23 MR. TURNER: The way that matters may have turned out and whether it turned out
24 commercially to be a bad deal for National Grid is one thing, the issue that the Tribunal is
25 concerned with is effects on competition and the market; you may reach your own
26 conclusions about the commercial merits of the deal.

27 THE CHAIRMAN: Mr. Turner, we are now half way through the morning session, is that a
28 convenient moment just to have a short break?

29 MR. TURNER: It is, madam.

30 (Short break)

31 MR. TURNER: Madam, with a fair wind I am going to do this, I think. Nonetheless, two further
32 points of clarification have been helpfully drawn to my attention before I continue. The
33 first is, we believe it is the case in relation to that British Gas table that the low bottom line
34 proposed Legacy MSA deal did factor in that British Gas had CMOs which it would be

1 using to replace meters which were cheaper than the installed meters. So that was included
2 in the effects.

3 Secondly, madam, on the issue that we were discussing before the adjournment, to clarify,
4 although we will look at those passages, our case is that the precise extent of an impact on
5 these individual CMOs is ultimately irrelevant or of very tangential relevance. We are
6 picking up on the remarks which you made at one of the earlier CMCs about this, which I
7 remember all my friends violently agreeing at the time, going into what caused any
8 particular change in their arrangements, what factors led to changes in volumes is a satellite
9 area which raises all kinds of considerations. At the level of principle you have our position
10 that the inclusion of exit charges as opposed to there not being any may be expected to have
11 an effect in leading to less replacement in the market than would otherwise occur.

12 The reason I was mentioning it in this context is for this reason only: Ofgem, for its age-
13 related counterfactual, has these replacement scenarios. It tells us what they are based on.
14 We are following that through to show that it was not based on anything solid.

15 I return then to the question of the execution of this age-related counterfactual in the
16 decision and the construction of the age-based system of PRCs under it. The Decision
17 purports to give what I am going to call 'a revenue-neutral' construction of its age-related
18 counterfactual. If you have open the Decision, we have already looked at 4.97 where they
19 say that the age-related PRCs are derived directly from National Grid's calculations for the
20 Legacy MSAs and Footnote 310 where they refer to the figures being calculated to achieve
21 the same revenue as the MSA PRCs over the lives of the meters.

22 But, then, if you go forward to paras. 4.160 and 4.161 on p.106 the matter is further
23 addressed by Ofgem. Paragraph 4.160 says,

24 "Figure 12 [on the facing page] shows the age distribution of National Grid meters
25 and plots an age-related PRC over twenty years. That is the one which is used in
26 the counterfactual. By averaging the PRCs instead of using age-related PRCs as
27 National Grid does in the NR contracts and as the CMOs do, National Grid
28 increases the level of early replacement charges that suppliers would pay on
29 removal of any of the pool of relatively old meters compared with the use of
30 equivalent age-related charges".

31 So, there again, implicitly it looks as though they think that we have taken the ages and
32 done an average which we have not. It then goes on at para. 4.161,

33 "The use of age-related charges that in some are equivalent to the PRCs in the
34 MSAs does not, as with the PRCs themselves, properly reflect customer-specific

1 sunk costs or take into account properly avoided costs. This approach shows that
2 even with a revenue-neutral construction of an age-related PRC there is a less
3 restrictive counterfactual arrangement and thus demonstrates that National Grid
4 has not adopted proportionate measures”.

5 There is then a qualification about the entitlement to get some particular amount of revenue.
6 It appears to us clear from this that they are saying that Ofgem believes it has arrived at a
7 revenue-neutral construction with its age-related PRCs. When it says in the second
8 sentence of para. 4.161, “This approach shows that even with a revenue-neutral construction
9 --“ it is talking about what it has just been discussing, which is its age-related counterfactual
10 and the structure of charges there in Figure 12. It cannot be anything else.

11 Finally, if you pick up the supplemental statement of objections, you see quite clearly that
12 this was their thinking in PD2, Tab 31, at p.1110. At para. 4.45,

13 “As the PRCs under the Legacy MSA are higher for a significant number of
14 meters, this suggests that National Grid could have structured the premature
15 replacement arrangements in ways that were likely to enable them to recover the
16 same revenues but were less restrictive of competition”.

17 It seems to us absolutely clear from the Decision itself that they have continued with that
18 line of reasoning. In the Decision that is what they think that they have done. This is
19 important because of the very recent *volte face* executed on this question by Ofgem since
20 the time of its defence. If you go to Tab 3 in CB1 you have the defence. At p.613 you find
21 para. 364. Ofgem’s defence says,

22 “The PRCs used in the counterfactual are derived from National Grid’s
23 calculations of the averaged PRC level for 2004”.

24 [It refers to 4.97. Then this, which has been withdrawn,

25 “If National Grid were to charge the same amount of rental as it does under the
26 Legacy MSA, it would therefore recover roughly the same amount under the
27 counterfactual as under the Legacy MSA. The whole point of the counterfactual is
28 to show that, even with a revenue-neutral approach, there is a less restrictive
29 counterfactual [Decision 4.161]”.

30 Now, that has been withdrawn because it has been recognised by Ofgem in correspondence,
31 quite fairly, that it is not right. But, for the reasons I have given, that is the reasoning in the
32 Decision - para. 4.161 and the other references. Why does it matter? Revenue neutrality is
33 essential if Ofgem is going to prove that it is the structure of the charges which is restrictive
34 - not just the fact that Ofgem is covertly making available larger numbers of free

1 discretionary meters. But, on inspection it turns out that that is exactly what is going on. If
2 you open the Notice of Appeal at Tab 2, I would invite you to turn to p.485 (of the external
3 numbering, within Annex 5), near the back. (After a pause): You have graphs here.
4 Those plot the Legacy MSA -- There is the straight line in blue for the Legacy MSA
5 replacement profile. Anything under that blue line is free to replace. What has been done in
6 red is to take the Ofgem age-related counterfactual, assuming that policy meters are free to
7 replace, assuming faulty meters are free to replace, assuming meters over twenty years old
8 are free to replace. It plots the red line to show you for each year of the contract, under
9 Ofgem's counterfactual, how many meters are committed to and how many are free to
10 replace. What you can see is that Ofgem's approach is simply committing the gas supplier
11 right from the start to renting fewer meters over the term and makes available many more
12 free meters every year to replace. The graph underneath has a slightly bigger drooping
13 belly and the reason for that is because Ofgem have also said that customer-requested
14 exchanges have to be paid for. So, those are going to be paid through the nose by the gas
15 supplier, but they are not treated as discretionary replacements. But, nonetheless, they are
16 within the overall level of replacements that take place and if you take that into account you
17 just get a slightly -- perhaps it is the scale of the graph, but you get a larger effect. Either
18 way, what you see is lower numbers of meters actually contracted for year on year.
19 Now, another way of getting at this point accessibly is if you turn back to Table 8 in the
20 Decision - CB1, Tab 1, p.89. There we have Ofgem's PRCs which it says it has extracted
21 from the Legacy MSA Agreement, and in the third column it has the actual number of
22 Legacy meters, as opposed to an even number assumed to be replaced free every year
23 under the Legacy Agreement, which are over 20 years as a matter of physical fact in any
24 year. Take, for example, year one, we know that the Legacy MSA makes available 980,000
25 credit meters each year, so that is the Legacy Agreement. This age related counterfactual in
26 year one is giving you 821,000 free older meters straight away, that is the first thing. You
27 have then got to add to that the number of free younger meters under Ofgem's scenario, and
28 just go back a page to table 7, where what they have looked at is the number of free meters
29 under their approach which are less than 20 years old. They have split it for the first three
30 years of the contract into policy replacement maintenance and customer requested
31 exchanges to see the overall numbers which would be either free to replace entirely or just
32 need to be paid for as non-discretionary in customer requested exchanges under Ofgem's
33 approach. It adds up over three years to about 2 million -- exclude CREs for simplicity, it is
34 1.5 million over three years, about 0.5 million a year. Add 0.5 million of the younger free

1 meters to the 821,000, which are the older free meters, and that gives you, excluding the
2 CREs, about 1.3 million for the comparison for the first year. If you add in the CREs,
3 which Ofgem also treats as compulsory but which have to be paid for, Ofgem allows for
4 almost 1.5 million replacements as against the glidepath number in each case, which is
5 980,000.

6 THE CHAIRMAN: Because table 7 is a three year total, so you have to add one third of that on to
7 the 821,000?

8 MR. TURNER: Yes, so 821,000 plus 500 I am corrected is about 1.3 million, and you play that
9 against the 980,000 under the Legacy MSA. So when you are doing this sort of thing it is
10 not surprising, and it is uninformative that Ofgem finds its counterfactual – hey presto –
11 makes it cheaper to replace additional discretionary meters beyond the glidepath allowance.
12 Ofgem’s response to this is in its skeleton argument at paras. 116 to 118 if you would turn
13 to that, it is on p.40 (947 of the bundle numbering). At para.116 Ofgem begins:

14 “116. NG criticises the age-related counterfactual on the grounds that it is not
15 revenue neutral. As NG recognises, this is principally because of the treatment of
16 policy replacements, which are free under the age-related counterfactual, whereas
17 they come out of the glidepath allowance in the Legacy MSAs.”

18 Pausing there, we do not say that at all. It is not because of the policy replacements alone
19 or mainly or principally, it is the overall effect. Ofgem then goes on in the rest of para. 116
20 to say that you could achieve revenue neutrality by doing something which we say is
21 illegitimate, which is that you make the so-called non-discretionary replacements – very
22 expensive – and you then have the option to make the additional optional replacements, the
23 discretionary ones very cheap. But, what you do then, is to force gas supplies, if you think
24 about it from their point of view, to enter into a completely different sort of contract from
25 the Legacy MSAs at all, and one which is completely contrary by the way to what British
26 Gas said it wanted to achieve in these negotiations, which I showed you at the outset, where
27 they essentially have to pay through the nose – huge amounts of money – by way of PRCs
28 for certain non-discretionary replacements. You could do it that way, but that is really
29 comparing apples with pears.

30 In para. 118 Ofgem reports National Grid’s point that if you want to make replacements
31 cheaper in the first few years of the contract or overall, you do not have to substitute age-
32 based PRCs for the Legacy MSA glidepath at all. All you have to do is to have a shortened
33 glidepath, or change its slope, just take a glidepath approach and make it go down sharply in
34 the first three years and then level off. Then they say Ofgem itself actually suggested using

1 a shorter glidepath. A shorter glidepath, they say here, rather than a change to the structure,
2 this offensive structure, would not have restricted competition; that is what they say at the
3 end of 118 – “also not restrictive and therefore not abusive.” They say the only reason why
4 they did not do that as their counterfactual – let us have a look at their reason: the reason the
5 Authority has not put it forward as a counterfactual is:

6 “the reason that the Authority has not put it forward as a counterfactual is that the
7 Authority has grounded its counterfactuals in what is seen in the real world.”

8 So in other words, Ofgem has lost any anchor of what is the benchmark for anticompetitive
9 foreclosure by this paragraph. Its position is that lower rental commitments from the gas
10 suppliers via an adjusted glidepath is less restrictive than the higher rental commitments
11 with a longer or higher glidepath. Yes, that is right, in the same way that higher prices are
12 less restrictive than lower prices. But, at the same time, Ofgem accepts expressly – if we
13 go back to para.113: “This is not an excessive pricing case.”

14 I could go on about this for a long time but you will hear more about it. I will conclude on
15 that by saying that Ofgem’s case on foreclosure developed in the Decision as a whole is not
16 coherent and, for all those reasons, it fails. That deals with the Decision on foreclosure.

17 It brings us to the so-called “No PRC counterfactual” which has come to the fore; the
18 announcement in the defence that this counterfactual in the Decision was only ever the
19 alternative and that Ofgem relies on its no PRC counterfactual in the Decision.

20 Pausing there, this description was odd, and I refer you to the reference in our reply and I
21 think the document is at CR2 158A, where Ofgem’s legal adviser, when the parties were
22 thinking about a list of issues for this case actually wrote to National Grid objecting to us
23 including this as an issue in the case, with the words: “The Decision does not compare the
24 legacy MSAs to a no-PRC alternative”. Their legal adviser says that to us. Nonetheless the
25 defence, and now the skeleton puts forward this case that the use of any payment of
26 completion arrangements and any PRCs in the long-term rental contracts should be treated
27 as restricting competition. Based on that idea Ofgem fastens on the regulatory P&M
28 contracts, which do not have any PRCs, and it says that those represent the appropriate
29 counterfactual for assessing whether there has been abusive foreclosure. I have made lots
30 of the points about this already so I can be very short.

31 Number one, you cannot prove that a particular structure of PRCs is abusive by pointing to
32 the fact that the allegedly dominant firm has got the option of doing nothing, i.e. remaining
33 on the P&M terms, any more than you can prove, for example, that a particular rebate
34 structure adopted by a dominant firm is abusive by saying it need not have had any rebates

1 at all. Similarly, you cannot prove that price cutting is abusive by saying the dominant firm
2 had the option of not cutting its prices, because that is more entrant friendly and less
3 restrictive of competition. You have to identify the norm which the dominant firm has to
4 observe. Where is the point when the line is crossed? We say that once you accept that
5 there is not anything in itself abnormal about early replacement charges, the only issue
6 remaining on Ofgem's case is whether the structure of the PRCs was abusive, which is the
7 focus of the Decision.

8 This new argument that National Grid could have just had no payment completion terms at
9 all, which it might have done, is entirely beside the point. The no PRC counterfactual, apart
10 from anything else, is irrelevant, because PRCs in themselves are not anti-competitive or
11 restrictive. In any event, this comparison that is made would not avail Ofgem at all in
12 showing that the structure of charges was abusive. Under this no PRC counterfactual you
13 would have what Ofgem's own representatives, or some of them, a voice within Ofgem,
14 recognise would be inefficient and artificial levels of replacement activity, we say are
15 actually obviously excessive.

16 As all the parties expected in the negotiations, the most likely practical alternative to
17 reaching a deal on the Legacy MSAs was certainly that everyone would remain on these no
18 notice terms. That would have entailed National Grid continuing to charge, because it
19 maximised its value, at the high price cap levels and the gas suppliers responding by taking
20 out meters quickly to maximise their value. I said at the outset today that the gas suppliers
21 weighed up those alternatives, those options, themselves. They are placed at the hub of
22 competition in this new competitive metering market. They saw not only the big benefits
23 for themselves which could be expected to be passed through, the price benefits, they
24 thought about disruption to customers, they thought about competition, they decided that the
25 rate of replacement envisaged by the Legacy MSAs left them and their customers better off
26 by any reasonable lights. We have seen that.

27 I turn then to the effects, the part of the Decision which, having dealt with foreclosure, says,
28 "and actually it caused a lot of harm, harm to consumers, harm to customers". It falls into
29 three main segments beginning at 4.102, if we return to the Decision, p.90. In this first
30 section, which is entitled "The actual impact on competition of the costs of switching", what
31 Ofgem is doing is examining the impact of the Legacy MSAs on the three British Gas
32 CMOs: CML, Meter Fit and UMS, and it looks at each of them in turn. In each case, what
33 it finds is that British Gas reacted to the MSA by dropping the volumes of work that it was

1 prepared to make available so that it would not go over the glide path. It says it has actually
2 foreclosed competition, this contract.

3 Next, at para.4.111 and following under the heading “The Legacy MSAs deprived
4 customers of the benefits of competition”, you have a price comparison which is carried out
5 by Ofgem. What this does is to compare the prices of individual meters under the Legacy
6 MSAs and under British Gas’s contracts with the CMOs. Ofgem finds the legacy prices are
7 higher and it concludes this has harmed the interests of customers and consumers.

8 The third stage begins at 4.120 on p.96. It is entitled “Restrictions in meter replacements do
9 not benefit customers”. Ofgem here refers to two matters of principle concerning the
10 interests of customers. It says at 4.120 that the MSAs are a way in which National Grid and
11 not gas suppliers have decided on, dictated, the rate of replacement of installed meters.

12 Dominant firms should not dictate the rate of replacement, it should be for competition and
13 customers to decide that.

14 At 4.122, there is an eyebrow raising paragraph, the proposition being that if gas suppliers
15 choose to replace a significant number of meters before they reach the end of their operating
16 life, this decision would not be inefficient or wasteful in any meaningful sense. This is
17 because the mantra of the dynamic benefits that would be brought.

18 Finally, fourth, over the page, 4.123 and following, under “Product innovation”, Ofgem
19 now finds that “artificially high” – the words used in 4.123 – switching costs are likely to
20 have distorted gas suppliers’ incentives to upgrade meters.

21 You see, if you go to p.98, footnote 336, an important footnote:

22 “For the avoidance of doubt, as the preceding paragraphs illustrate, it was entirely
23 predictable at the time of entering into the MSAs that the ability to introduce new
24 technology would be impeded.”

25 I can take each of these briefly in turn, and I have handed up notes on two of them.

26 Impact on the CMOs: madam, as you indicated at the September CMC, we accept the point
27 that the precise impact on these CMOs’ volumes of business with British Gas are a matter
28 of tangential relevance at best. Our key points as far as we see them are, number one, I
29 have said already that we accept the general principle that under the P&M terms its likely
30 that there would have been more replacement of meters by gas suppliers.

31 Number two, we do not accept that under the age based structure of PRCs, a properly
32 construed age base structure, it is likely that there would have been any more replacement
33 of meters by gas suppliers and Ofgem counterfactuals, certainly for the reasons I have given
34 about its flaws, do not show that.

1 Number three, if it should be necessary to debate in this court the precise effects on each of
2 CML and Meter Fit of the coming on to the scene of the legacy agreements, we say, as I
3 have said, that the hard evidence bears out no impact on Meter Fit whose volumes are not
4 reduced and no obvious impact on CML either. All the effects, because there were effects –
5 we accept that – were focused on UMS, the National Grid entity, where there was a
6 significant reduction in the volumes that it had as a result of the re-negotiation of its
7 contract with British Gas.

8 That is all I want to say about this part of the Decision which focuses on the precise impact
9 on these CMOs and the causes of it.

10 The price comparison which began at 4.111 and following: that is dealt with in our
11 supplemental submissions and I will merely give you the references. Those are at CB2, tabs
12 8 and 10A. Our overriding point is that Ofgem has swung a large red herring across the still
13 waters of the court - in short, because they fail to take into account the price reductions via
14 the MSAs on the basis that any businessman would do, which is the across-the-board
15 savings from which the gas suppliers and the gas consumers benefit. That is the appropriate
16 basis to consider the benefits of the act of competition that led to the MSAs and the price
17 reductions in them.

18 THE CHAIRMAN: You are saying then that a businessman would take into account the fact that
19 the reduction goes across the whole of the Legacy meter base rather than relates just to the
20 new meters that are installed. But, how is that consistent with your argument that having the
21 Legacy meter base does not give you an advantage in getting the new business?

22 MR. TURNER: If being able to reduce price is an advantage you are able to reduce price.

23 THE CHAIRMAN: You are able to spread the reduction. That is the sort of dominant firm's
24 discount, is it not? It is a kind of loyalty thing - you spread the reduction over a much larger
25 number of units.

26 MR. TURNER: One has to be careful. If you express it like that, it sounds as though we are
27 gaining some economies of scale by spreading over a large base. It is not. For every unit,
28 every single meter among the population that is subject to these agreements -- For every
29 single one there is the same cost reduction. There is no spreading of fixed costs giving you
30 economies of scale, or anything like that. All meters are reduced by the same equal amount
31 across the board. So, the only advantage is that I am able to take a bigger hit -- I am able to
32 drop my meters in price. It is not an economies of scale issue.

33 Effects on nascent competition. The frustration of dynamic efficiencies from being
34 achieved. That is the third area. If you pick up our skeleton again in CB2, Tab 14 we

1 address that at para. 68. We see this as essentially linked to the thesis in the Decision, the
2 reasoning which I have not fully addressed yet, that the first three years are the crucial
3 years. Like a young plant, that is when the competition is embryonic and nascent, and it is
4 particularly crucial then not for there to be any impediment to the CMOs because you need
5 to get them going. That is why, in the paragraph we looked at earlier, Ofgem dismisses
6 National Grid's point - although it accepts it - that you can switch out a very substantial
7 number of meters under the MSAs over a longer term. It says, "Ah! But you have to focus,
8 for the analysis, on the first three years". We make in response to that, at para. 69 of our
9 skeleton, three short observations. At para. 69(a): no-one is suggesting, and Ofgem does
10 not, that these CMOs were not able to establish viable businesses in the first three years, or
11 that they have not gained a large chunk of the new and replacement work, however you
12 define the market; (b) that in view of that, even if you had more cheap or free replacement
13 opportunities in the first three years, why, you ask, is that going to lead to this stronger
14 competition from everybody in the longer term than if, if the replacement profile is
15 different, you have more replacement opportunities further down the line to take advantage
16 of? It comes out in the wash. (c) is a point about, why are you assuming anyway that over
17 twenty years of age you should necessarily draw the line and say that these meters become
18 free to replace?

19 What Ofgem seems to suggest in the Decision, particularly at para. 4.166, is that
20 competition needed a vigorous helping hand in the first three years and that its age-related
21 counterfactual with what we say are its skewed charges helped achieve that. Our response
22 is that we cannot see any basis for taking that as your logic for foreclosure.

23 The last point is the impact on innovation.

24 THE CHAIRMAN: I suppose that leads us to a question of whether, in its capacity as an enforcer
25 of Article 82, Ofgem is properly influenced by considerations which in its capacity as
26 regulator of the market and opener-up of this market to competition, factors which would be
27 relevant to it in that latter capacity, whether those are also relevant, and it is the capacity in
28 which it is before us in this case because one can quite see that as a regulator Ofgem would
29 say, "Well, it is important when we decide what the structure of the market is going to be
30 put in place, that competition is encouraged in the first three years". But, whether that is an
31 appropriate way for it to approach its competition law enforcement role may be something
32 we need to think about.

33 MR. TURNER: That is a very interesting point. It is a good point. We say, as a matter of
34 principle, obviously for the competition enforcement rules one is not in the business of

1 entry assistance. It is a range of options open to even a dominant firm. It has those options
2 available, but it is not the question of using the competition rules to promote some particular
3 outcome.

4 However, secondly - and I would emphasise this - I have seen no basis for even assuming
5 that in the first three years this kick-starting effect is somehow of particular value to the
6 overall development of the competitive market.

7 THE CHAIRMAN: No. That was your first point.

8 MR. TURNER: Yes. I turn, then, to impact on innovation - the last leg of the foreclosure and
9 abuse section. Ofgem's case, as you have seen, was entirely predictable - that the ability to
10 introduce new technology would be impeded. That is at odds with the assessment of all the
11 major gas suppliers which you have seen. In its case (if you have open paras. 4.123 to
12 4.126) there is actually very little relied on for this strong statement about 'it was entirely
13 predictable'. In fact, there are only two things that are relied on: (1) in para. 4.124 is a
14 comment from a BG official, Mr. Robin Beasley, which was out of line with the full
15 detailed assessment of British Gas, which you have in the board paper, to which Mr. Avery
16 also speaks in his witness statement. Paragraph 4.125 is relying on EDF and its
17 perspective. But, even EDF did not regard the MSAs as impeding the introduction of new
18 technology. I will not go back to it, but one of the board papers that we looked at yesterday
19 was the EDF board paper (BP1, Tab 6). If you go back to the reference I went to then you
20 will see that EDF itself said, "This is not going to harm new technology when they looked
21 at it internally". But, moreover, and even more strongly, when EDF made a submission to
22 Ofgem in this case -- Let us have a look at what it said at PD4, tab 82 at p.2353. We are
23 now in a letter to Ofgem from EDF, when it has seen what Ofgem is doing. It is referring to
24 what it calls the statement of Objections of 27th April 2007 (that is the supplemental
25 statement of objections) and EDF is giving its views. At 2353 look first at paras. 16 and 17.

26 "16. Ofgem refers in paragraph 3.72 [the SSO] to the "real risks" taken by the five
27 major domestic gas suppliers in signing the MSAs, that they would be unable to
28 respond to large scale increases in the demand for smart metering. EDF Energy
29 considers that this assertion is unduly lenient. By signing these agreements, the five
30 suppliers in question ensured substantial returns to their shareholders.

31 17. Furthermore, the assertion overstates the risk position of the suppliers in relation
32 to smart metering. It was never likely that there would be large scale increases in
33 demand, because the realistic expectation was that smart metering would only be

1 introduced gradually, and therefore the glidepath in the MSAs would have enabled the
2 suppliers to respond to predicted demand.”

3 Now, this comment as well everything else on the file does not make it into the Decision
4 which finds that it was entirely predictable that smart metering would be impeded. While
5 you are on that page you may have noticed higher up that this falls within a section entitled:
6 “Absence of buyer power”, where EDF actually takes issue with Ofgem as having
7 mischaracterised the gas suppliers’ lack of buyer power. If you read paras. 13 and 14 – take
8 14:

9 “As Ofgem rightly finds in paragraph 3.73, NG was a “must deal” partner, due to
10 its large installed base of meters. However, as paragraph 3.73 also finds, suppliers
11 had a choice of remaining on the P&M contracts or signing the MSAs. Thus,
12 although suppliers were unable to negotiate changes to the terms of the MSAs
13 there was no inescapable or unavoidable compulsion on them to sign the MSAs.
14 Ofgem has therefore over-stated the suppliers’ lack of bargaining power.”

15 My comment on that is that he is right in what he says about the balance of bargaining
16 power. He is wrong in fact in what he says about suppliers negotiating changes to the terms
17 of the MSAs. You have seen some of the evidence and we have set out in our submissions
18 the concessions and the changes that British Gas in particular rung out of National Grid and
19 they led the charge. National Grid’s view was that once it had crystallised the form of the
20 Legacy MSA contract that should be offered to all parties on an equal basis to avoid a non-
21 discrimination problem. To the extent that that is what the author is referring to, that may
22 be right, but beyond that the comment is misconceived.

23 THE CHAIRMAN: Were there negotiations with EDF about the Legacy MSA before they
24 decided not to sign it?

25 MR. TURNER: Yes, you may remember, although I think some of the negotiations took place a
26 little bit later than the others, that that very colourful document that I took you to from EDF
27 was the one where they said “They have made us this offer ...” – that was where I read out
28 the figure that I should not have read out – “.. why are we rushing around, all risk sits with
29 Transco; they are the ones who are feeling the pain”, or words to that effect. They did
30 consider it at that stage, yes and it was offered to them.

31 The next point is this, and I have foreshadowed it, the Legacy MSAs were, in fact, more
32 congenial to smart meter replacement than the P&M contracts, and if you think about it you
33 can see why. The no notice contracts which would have encouraged more replacement by
34 the CMOs with their PRC arrangements (very high PRCs in the first years and extending

1 over a 20 year period) would have meant replacing over the first three years, that is up until
2 2006, dumb meters with cheaper dumb meters, subject to these very high PRC protections.
3 So if smart meters then turn up on the horizon the gas suppliers are actually worse off in
4 being able to put in the new technology than they are for Legacy MSAs – a point which was
5 made by I cannot remember which one of the gas suppliers in the Board paper, which we
6 went to yesterday.

7 Next, no one in the industry has identified the charges in the MSAs, the charging structure,
8 certainly as a block to the introduction of new smart meters, so far as we can tell. Even
9 Ofgem, in its response to the BERR Consultation 2007 has identified other issues. That is
10 in the notes that I handed up.

11 The final conclusion, and then I hope to deal briefly with maintenance, objective
12 justification and penalty very rapidly in the remaining time. There is no case on any
13 sensible basis of comparison with an alternative world or benchmark, that MSAs resulted in
14 any harm to customer or consumer interests. On the contrary, and the gas suppliers are not
15 here intervening, but you have seen their documents, these are contracts very much in
16 customers and consumers interests.

17 I turn then from early replacement charges to meter maintenance. We know from para.4.21
18 of the Decision, if you turn to that again (p.70, CB1) that maintenance bundling, not having
19 a separate charge for the maintenance, is not alleged as a separate abuse. It is said to
20 exacerbate the foreclosing effect of the MSAs, particularly in the case of PPM, (prepayment
21 meters) on the basis that National Grid is excluding CMOs from the chance to replace faulty
22 meters when they carry out maintenance visits, and the detailed reasoning is contained at
23 4.81 to 4.85. Our submissions on this, in case I need to abbreviate now, are in para. 80 of
24 our skeleton, and I will make the following points.

25 First, so far as the prepayment meters are concerned I return to what I said at the outset,
26 Ofgem has not positively found a foreclosure effect resulting from the early replacement
27 charging structure in the Legacy MSAs which would then be increased by not allowing
28 CMOs to maintain its installed PPMs. We discussed at the outset the point that Ofgem uses
29 the phrase in para. 4.79: “The impact is likely to be less pronounced than in the case of
30 DCMs. However, in its skeleton (para.167) Ofgem says that is the positive finding, and we
31 say that is not right, and that is fanciful.

32 Secondly, it is in any case perfectly legitimate and unobjectionable for National Grid to
33 maintain its own assets rather than allowing its competitors to do so. I will give you the
34 reference only to this because we refer back in our submissions in a Chinese box style to

1 our first set of written representations at paras. 286 to 287, PD1, tab 8, p.253. In fact, I may
2 have the time to cover this, having given you that reference if you would not mind picking
3 up PD1 I will just clarify what our point is. As I say, it is PD1, tab 8, p.253. (After a pause)
4 It is actually quite short, I need not have bothered.

5 “The combination of Meter provision/maintenance in the MSAs reflects custom
6 and practice. It is a feature of the RGMA contracts. There was an extended period
7 of negotiation of the new RGMA contracts in the period 2001 to 2004, which
8 involved open industry meetings (often including representatives of the Authority).
9 Although at the beginning of that process some Gas Suppliers asked National Grid
10 to consider separating out maintenance of its Meters (in particular [industrial] and
11 [commercial] meters), at the end of the process there was consensus that it was
12 reasonable for National Grid to retain the right to maintain its own assets, and no
13 one sought regulatory intervention to overturn that position.”

14 There you have it, it is not some unique feature of these Legacy MSAs, it is there in the
15 P&M contract. Indeed, the tariff cap, the price cap, set by Ofgem bundles maintenance and
16 provision.

17 The third point is that the regulatory cross-subsidy, as we describe it, has this practical
18 implication: it means that National Grid’s PPMs uniquely have been constrained to be
19 priced at less than their full cost of provision. It is an important element of the factual and
20 economic context because it means there is not a significant possibility that gas suppliers
21 want to replace the installed National Grid PPMs with substantial numbers at least of
22 CMOs’ PPMs while this regulatory backcloth is there. The evidence shows that that is
23 exactly what influenced British Gas at least in its approach to the matter. We saw one part
24 of the one of the documents yesterday touching on this. That is para.80(c) of National
25 Grid’s skeleton.

26 That is all I wanted to say about the PPM side of things.

27 Turning to DCMs, credit meters, it is not, in my submission, a fair reading of this Decision
28 that the meter maintenance issue is a real concern. Would you go to the Decision, the
29 conclusions on abuse at 4.182, p.112. What you see is that in its conclusions Ofgem begins
30 at 4.181 by dealing with the abuse resulting from the cumulative effects of the early
31 replacement charging arrangements. That is 4.181. You then have the findings on the
32 maintenance in 4.182, and what they say is:

1 “Furthermore, irrespective of whether gas suppliers use competitors to replace
2 meters, NG will continue to replace a significant proportion of prepayment meters
3 during maintenance visits.”

4 The reasoning runs on from that.

5 “The Authority considers that this increases the foreclosing effects of the early
6 replacement charging arrangements ...”

7 In its conclusion, therefore, it is clearly and strictly limited to the prepayment meters and
8 appreciable addition to foreclosure arising from not allowing CMOs to replace PPMs in
9 maintenance visits, because that is all it says.

10 THE CHAIRMAN: The fact is that if they replace it then that is one against the glide path, is it
11 not, it is one free allowance meter taken up or used up, whereas if they just maintain it and
12 do not replace it then there is no effect on the main number of free allowances. So it is the
13 combination of the fact that the maintain them and they, in fact, replace them and that that
14 replacement counts towards the glide path which is the impact of the bundling of
15 maintenance on the case.

16 MR. TURNER: Madam, you will remember that this was an issue at the CMC.

17 THE CHAIRMAN: That was a different point. That was a point about density of operations and,
18 “Oh, well, if we could do the maintenance work then that would help us organise our
19 work”, and that we are not going into. Just purely looking at the effect of the agreement and
20 maintenance, I think we ----

21 MR. TURNER: Madam, we say not. We perhaps then need to look again at the reasoning. It is
22 not a question of the CMOs being disadvantaged – forget density for a moment – because
23 they cannot get a profit from doing maintenance operations.

24 THE CHAIRMAN: No, I am not saying that at all. I am saying that it is because there is a
25 tendency to replace meters rather than maintain them and that that replacement uses up one
26 of the free allowances, that is the relevance of the maintenance bundling.

27 MR. TURNER: Madam, we say no, because the way that it is expressed in the Decision – let us
28 look at their reasoning – is simply that if you allow CMOs to do maintenance work on the
29 meters – take the PPMs – in some cases where maintenance is required, and I think the
30 evidence is that it is about 85,000 a year out of 600,000 maintenance visits a year, you
31 cannot simply maintain it, you have to replace it. In that group of cases, the 85,000 a year,
32 National Grid puts in its meter, a new meter of its own instead, and the CMO which has not
33 been allowed that chance cannot put in a meter of its own.

1 Let us have a look at the reasoning, I will go it, because that is the logic of the Decision.
2 Would you go, first, to 4.4(b), you have the first reference, which is that under both these
3 agreements:

4 “... bundled meter maintenance appreciably increases the foreclosing effects of the
5 Legacy MSAs where maintenance visits lead to the replacement of meters which
6 are automatically supplied by NG under the N/R MSA.”

7 The next reference is 4.21, p.70:

8 “We do not consider the bundling of maintenance with the provision of meters
9 under the MSAs to be a separate abuse. The bundling of maintenance clearly
10 exacerbates the foreclosing effects of the MSAs. This is because even where a
11 supplier is using one or more CMOs to provide new and replacement meters, NG’s
12 maintenance of its legacy meter stock will lead to NG replacing both PPMs and
13 DCMs. NG will then supply these meters under the N/R MSAs. The number of
14 meters NG replaced as a result of such maintenance visits is significant in the
15 context of the foreclosure effects created by the early replacement charges ...”

16 and then it is a numerical point –

17 “... (for example 15% of PPMs are replaced on maintenance visits ...)”

18 that is the 85,000 –

19 “... (...which accounts for 30% of the glide path). But they would not be sufficient
20 or significant enough in the absence of these other features to constitute a separate
21 abuse.”

22 You then have the major explanation of the case at 4.81-4.85, and beginning at 4.83:

23 “When a legacy meter is replaced by NG on a maintenance visit (other than where
24 that visit followed an emergency call-out), the newly installed meter will be
25 provided to the relevant supplier under the N/R MSA. Since the N/R MSA also
26 bundles the maintenance with charging for the provision of existing PPMs, a
27 significant proportion of PPMs provided on the N/R MSA will also be replaced by
28 National Grid on maintenance visits, again irrespective of whether a supplier is
29 appointed as CMO to undertake their meter replacement activity.

30 4.84 Therefore, a signatory to the MSAs which has ‘elected’ out of the N/R MSA
31 by BGT will find that it is nonetheless contractually caught under the N/R MSA
32 for meters replaced as part of maintenance of the Legacy meter stock. In both
33 situations, the length of the arrangements will effectively be prolonged (the MSAs
34 will in reality be indefinite ----“

1 which we dispute.

2 Then, finally, the only other reasoning you have is what is in 4.182 which is all about
3 replacing -- Because we do the maintenance and not the CMOs we get the chance to put in
4 our own meter and they are denied that opportunity. That is how we read the case against
5 us. We have not read it in another way. If I may, Madam, it may be that that is something
6 that can be picked up subsequently, depending on what others make of it. "Objective
7 justification." I shall be very brief. Our skeleton covers that at paras. 84 to 87. I shall not
8 take you there, but the essential point is that for lots of the reasons I have already covered --
9 Fully efficient contracts. They gave efficient incentives as opposed to the distorted
10 incentives under the previous arrangements which Ofgem itself was worried about. Not just
11 in the interests of efficiency, but also in the interests of consumers. I have developed that.
12 Finally, Penalty and Directions. That is in paras. 88 to 97 of our skeleton.. It gives all the
13 relevant references which I shall not rehearse. But, I will refer to Ofgem's pushback on the
14 points that are in issue in its skeleton at CB2, paras. 179 to 197. This is quite an extensive
15 part of the Ofgem skeleton. In passing, you see at 180.2 that despite the embracing of the
16 'no PRC counterfactual' there is a recognition that some sorts of early replacement charges,
17 i.e. those which are 'normal' in the circumstances of the relevant market and/or which do
18 not lead to foreclosure would be compatible with competition law does not lessen the
19 obligations on National Grid. So, even here, even in their skeleton there is still at least a
20 recognition that you can have some sorts of charging arrangements which are normal.
21 However, the three points I will make on penalty and what Ofgem says are as follows: at
22 para. 180.4 there is a reaction to our point that Ofgem's case changed significantly. I have
23 shown you the way that they presented it in the first SO where the use of any payment
24 completion charges would have been an abuse in and of itself and Ofgem directed National
25 Grid, or proposed to, not to include any, but only to compete on the basis of short-term
26 arrangements and dropping prices. That did fundamentally change when you came to the
27 April 2008 supplemental statement of objections. What is said is that the case changed in
28 only limited ways. We say that it moved from that original position to this detailed
29 quantitative claim which you find in the Decision ultimately. That case in the Decision is
30 embraced by any industry participant, and it never has been, and even the CMOs who are
31 here today, because their interest is obviously in trying to achieve a situation where there
32 are maximum opportunities available to them have not said that it is any part of their case
33 that, "This age-based structure would have been wonderful for us, would have worked
34 well".

1 The second point: so far as Ofgem's involvement in all this is concerned what we pointed
2 out in our Notice of Appeal was that some of the basic ideas which are the focus of criticism
3 in the Decision -- the use of early replacement charges, the glidepath -- although not all of
4 the details of the contract, that is true, were discussed with Ofgem's officials. National Grid
5 was also aware, as many other people in the industry were aware, that Ofgem was
6 concerned about premature replacement and thought it was inefficient. We can give you
7 numerous references for this. It is against that background, we say, that if you ever get to
8 the stage of finding National Grid guilty and needing to consider what penalty to impose,
9 that has to be taken into account. A significant voice within Ofgem - and, indeed, we say a
10 dominant voice at the time of the February 2003 management paper - considered that the
11 negotiations over the MSA contracts would help to deal with an industry problem and that a
12 market solution could lead to an efficient industry outcome.

13 Ofgem says in its skeleton at para. 186.1 about this that up to February 2003 we were
14 talking about discussions relating to National Grid's proposal to modify the network code
15 and that after February 2003, once it was clear that National Grid was looking at a separate
16 contract, Ofgem steps back and has no further role. You have seen some information on this
17 already. It is simply, we say, not the case in fact. Well before, and into, February 2003
18 Ofgem was aware that separate contracts were being negotiated, and it expressed its view
19 about that. It cannot be controverted.

20 Ofgem says, "Are you making a legitimate expectations argument?" at para. 183 of its
21 skeleton, and it declares at the end of that para. 183, "National Grid must clarify this at the
22 earliest opportunity". I will now clarify this at ten to one, in finishing my opening
23 submissions. We are not making a legitimate expectations argument - namely, an argument
24 that we had a legitimate expectation that no-one would challenge this behaviour as
25 unlawful. We are making a point which goes to, if there is any need for a penalty,
26 mitigation and I have explained why.

27 The last point at para. 192.1 of Ofgem's skeleton. This is a response to us pointing out that
28 in any event this case has got quite a lot of complex and special features, and if you are
29 going to find us guilty you really have to take into account that it presents unusual
30 difficulties. It was by no means obvious to National Grid that there was any abuse of
31 dominance. You have seen from at least two of the internal National Grid documents - and
32 you will hear also if he is asked about it, from Mr. Shoesmith - that National Grid saw its
33 obligation to facilitate competition. National Grid, in arranging its charges, was punctilious

1 about, “Well, is this a problem from the point of view of the law and competition?” It acted
2 accordingly. That also needs to be taken into account.

3 THE CHAIRMAN: I think there is authority - which no doubt someone will point me to if it is
4 relevant - about what you have to be negligent about in order to trigger the ability to impose
5 a fine.

6 MR. TURNER: Yes.

7 THE CHAIRMAN: Now, you have said several times that you accept that these contracts
8 generated dis-incentive for people to replace meters ----

9 MR. TURNER: Above the glidepath level.

10 THE CHAIRMAN: -- above the glidepath -- the free allowance -- below the glidepath level.

11 MR. TURNER: Below it, yes.

12 THE CHAIRMAN: To that extent you accept, I suppose, that there is therefore foreclosure
13 though you would say it is not anti-competitive foreclosure.

14 MR. TURNER: I was on the point of saying foreclosure but not as we know it.

15 THE CHAIRMAN: Right. Now, whether or not you thought that was against the law, I am not
16 sure are you relying on that as part of there was no negligence and therefore no fine, or just
17 as a mitigation point that if there is a fine it should not be so much as has been imposed?

18 MR. TURNER: Madam, it is the latter, your reasoning is quite right, that if the company foresaw
19 that its behaviour would have what would then be characterised as adverse effects, then
20 whether or not it applies the correct label is a different matter and, yes, that is the legal
21 position. But what that then does is give the Tribunal, or Ofgem, the jurisdiction to impose
22 a penalty and what we then draw attention to is that when you are considering mitigation it
23 becomes a very important factor.

24 THE CHAIRMAN: In your skeleton you take both points though, you say there was no
25 negligence, and therefore there should be no fine and, in the alternative, if there was
26 negligence then the fine should be lower. Do you still maintain those ----

27 MR. TURNER: Thank you very much, madam, I will look at that and let you know if we
28 maintain our position on that.

29 THE CHAIRMAN: Yes, thank you.

30 MR. TURNER: At all events, and looking at it for the moment as a mitigation point, when we
31 look at 192.1 Ofgem’s point is:

32 “ ... to the extent that this case raises new or complex issues, that simply serves to
33 highlight how important it was for NG to seek proper advice and to act with
34 caution;”

1 A simple answer, the evidence shows that National Grid acted with immense sensitivity and
2 caution.

3 Before I close, there is one point, although not a huge point, I have been asked to draw to
4 your attention. If you turn to Mr. Avery's witness statement, which is WS1, tab 2, he
5 makes a point which I failed to but should have done, and that is at para. 105 on p.621. I
6 would like the Tribunal to bear in mind at this point who Mr. Avery is. He is not a
7 National Grid official, he does not have to give this evidence. He is giving his evidence
8 because this is exactly how he saw it, and he was the senior British Gas man.

9 "105. In retaining maintenance for itself National Grid did not block off a route to
10 market. If a call comes in from a customer that requires a meter to be maintained
11 British Gas' call centres can direct the call to whoever they like. So if they want
12 their CMO to take the opportunity to switch out a meter then they can direct the
13 call ..."

14 They get a false call, and they can say to the CMO "You go and replace that."

15 THE CHAIRMAN: Yes, well that was the point that I had in mind when I explained how I
16 thought bundling of maintenance was relevant because the idea in the Decision of there
17 being a maintenance visit is not quite right, because it is up to the gas supplier to decide
18 whether there is going to be a maintenance visit or not, and we have seen other people's
19 evidence that says that whenever you get into the house you swap out the meter if you can,
20 nobody is repairing these meters at the moment. So that is why was my interpretation of the
21 effect of the bundling was slightly different from what you showed me in the Decision.

22 MR. TURNER: Madam, I am sorry, I now understand, the penny has dropped at this point. You
23 will have seen, perhaps, somewhere else in Mr. Avery's evidence, or at any rate it is part of
24 the documentary record, that the original idea that British Gas had for its CMOs was that
25 they would replace meters on a "first visit fit principle" – that is the phrase used. So they
26 go along and once they are in the household they put in their own meter. They then drew
27 back from that to allow National Grid to continue maintaining its prepayment meters.

28 THE CHAIRMAN: Well not maintaining them, replacing them.

29 MR. TURNER: And replacing them, which would be, yes, with its own meters, and then subject
30 to its own points scale.

31 THE CHAIRMAN: Yes, and the question is why did they draw – well that may be the question –
32 why did they draw back from doing that?

33 MR. TURNER: Because it was much cheaper.

34 THE CHAIRMAN: No doubt other people will give a different reason.

1 MR. TURNER: Well you will have the evidence on that.

2 THE CHAIRMAN: It is just that maintenance bundling is quite a sophisticated point; what the
3 effect of that is.

4 MR. TURNER: Yes. It does remind me there was one other point I should also make on the
5 same topic. It is drawn to my attention PPMs are not often replaced. We are talking about
6 85,000 a year, but that point applies in spades for the credit meters, insofar as Ofgem is still
7 saying, which I believe they are, “our Decision also applies to the possibilities for credit
8 meters to be replaced on maintenance visits.” That is because, certainly when you come to
9 the credit meters, the number of maintenance visits and the number of DCMs which are
10 replaced on maintenance visits is absolutely trivial. It is in the agreed statement of facts at
11 para.16. It is in the Decision itself and it amounts to only around 11,000 a year out of a
12 legacy population of 17.5 million in 2004. The Decision refers to that, if memory serves, at
13 2.21 – it is less than 0.001 per cent of all credit meter replacements, and cannot be viewed
14 as material.

15 Madam, that, subject to any questions, concludes our submissions. I have not dealt with the
16 order of witnesses which I can briefly mention now, because the Tribunal’s letter asked us
17 to address it.

18 THE CHAIRMAN: The only point I would make, but it is not a question for you to answer now,
19 is that how the PRCs that you showed us the table of in the Legacy MSA, I am not clear in
20 my own mind where those come from, what those represent. You said that they are not
21 some kind of averaged age-related calculation. I am assuming that here is some present
22 value of future rental payment?

23 MR. TURNER: Absolutely.

24 THE CHAIRMAN: If you could just point me at some time at your convenience, or produce a
25 note or something which explains how those amounts which dwindle down ----

26 MR. TURNER: Yes, I took you to paragraph 148 in the agreed statement of facts. The preceding
27 paragraphs, which I referred to but did not read, set out exactly how it was done (paras.145
28 to 147). Underneath that, if you wish, I can also refer you to other detailed descriptions
29 which have emerged of it. But the essential idea is that you start with the notion that you
30 are renting a portfolio of meters.

31 THE CHAIRMAN: Let me stop you there, Mr. Turner, I think we will take the short
32 adjournment, I just make that point. I will look at those paragraphs and then if I am still
33 unclear I will let you know.

34 MR. TURNER: I am obliged.

1 THE CHAIRMAN: So we will come back at 2 o'clock and listen to Ofgem's submissions, thank
2 you very much, Mr. Turner.

3 (Adjourned for a short time)

4 THE CHAIRMAN: Yes.

5 MISS CARSS-FRISK: Madam Chairman, may I begin by handing up yet a further version of the
6 Decision, I am afraid, but I hope it will help. It has the references to all the documents in
7 the footnotes, all the bundle references typed in, and it is also properly paginated, so it can
8 be used instead of, if need be, or in addition to, the version that we have. (Same handed)

9 THE CHAIRMAN: So should we slot that in then to CB1?

10 MISS CARSS-FRISK: That would probably make sense. I appreciate, of course, that you have
11 been marking up the version you already had, but it may just be useful for you to have those
12 document bundle references there. You may want to have both, in fact, behind the same
13 tab.

14 I should also explain that this version contains a few corrections, I believe wholly
15 uncontroversial *errata*, to the Decision that had been made after the Decision was issued but
16 had not found their way into the copy you had. So this is now the final complete and
17 correct version.

18 I would like to begin, if I may, with a thumbnail sketch of our vision of competition, of how
19 we see the key points in this case, and then come back to address you in a little more detail
20 on each aspect. I do not propose here to respond to all the factual matters that Mr. Turner
21 mentioned yesterday, but I may come back to those in due course in dealing with the other
22 matters.

23 Turning to the thumbnail sketch, we say there was one market for legacy and new and
24 replacement meters, as is powerfully illustrated by the fact that Grid had this fear that it
25 would not recover its sunk costs precisely because new and replacement meters were such a
26 good demand side substitute for Legacy meters. That fundamental point is not altered by
27 the fact that Grid had sunk its costs in the Legacy meters. We do say that Grid clearly was
28 and is clearly dominant in that single market. Of course, it had a market share as at January
29 2004 of 97 per cent. We say there is nothing here to displace the presumption that that puts
30 it in a dominant position.

31 We accept that the largest gas supplier, British Gas, had some market power, but by no
32 means sufficient to negate the power of Grid in this case. The fact is that Grid was a "must
33 deal" partner for the suppliers, and British Gas would be compelled on any view, including

1 on its own assessments, to take a very large proportion of its meters from Grid for a
2 considerable number of years.

3 We know that Grid was extremely fearful of the potential impact of competition here, and it
4 set about – it makes no bones about that – finding some way of seeking to recover its sunk
5 costs, which of course then resulted in the MSAs, which allow for, and of course that is
6 important, no more than about 5.5 per cent of the opening legacy stock being replaced each
7 year free of charge. Of course, because the exit charges in the Legacy MSA took no
8 account of the age of a particular meter but were based on an average, there was no
9 opportunity for suppliers to seek to mitigate the impact of switching costs by replacing older
10 less valuable meters first.

11 We say the net result of the Legacy MSAs is clearly that the volumes of meter replacement
12 that were available to the CMOs have been restricted. There has been an actual foreclosing
13 effect of the MSAs and that is very clear, we will say – or will become clear – from, not
14 least, the evidence of the interveners, whose evidence we have been told will not be
15 challenged.

16 Of course, I should add that the Authority does not need to show actual effect. Likely effect
17 is sufficient, but in this case it did find, in our submission rightly, an actual effect on
18 competition.

19 What is Grid's fundamental answer to this? As we see it, it is really to say that because we
20 had sunk our costs, we are entitled to guarantee a certain revenue stream in order to recover,
21 they would say, part of those costs. We are entitled to do that regardless of the impact on
22 competition. No undertaking has such an entitlement, and that applies with particular force
23 to an undertaking such as Grid that was and is dominant.

24 We have referred, of course, to dominant undertakings' special responsibility, which means
25 that what might be seen as normal permissible behaviour in a competitive market would not
26 be permissible necessarily for a dominant undertaking. Grid has never, so far in these
27 proceedings and still has not, faced up to that special responsibility. I do not believe that
28 Mr. Turner has dealt with it at all so far.

29 Of course, it is true that it is difficult to identify what then would be a normal competition in
30 a market such as this precisely because of Grid's dominance. What we do say is clear is
31 that there were a number of options available. There was the age-related approach, one of
32 our counterfactuals, there was the possibility of a contract with no premature replacement
33 charges, and indeed the possibility of up-front installation charges.

1 Ultimately, whether Grid is able to recover its sunk costs or not, or even part of them,
2 should be, of course, a matter for competition properly applied, and the problem with the
3 MSAs, as I have suggested, is that they really proceed on the basis that Grid is entitled to
4 guarantee this revenue stream regardless of the foreclosing effect.

5 Of course, Grid has made a lot of the idea that the gas suppliers were happy to sign the
6 MSAs, even wanted to do so, but it is perfectly possible for an arrangement to be abusive
7 even if it is desired by the dominant undertaking's commercial partner. That in no way, in
8 our submission, provides an answer. The fact is that these contracts effectively allowed
9 Grid to set the rate at which meters would be replaced and hence to determine, in a sense,
10 the level of entry of the CMOs and their ability to expand in this market. So the MSAs are
11 fundamentally foreclosing. I am not sure there is really much debate about that at this stage.
12 Perhaps the only question, the only main question, that remains is, was Grid entitled to
13 recover its revenue stream because it had these sunk costs, notwithstanding the foreclosing
14 nature of the contracts, and we, of course, say not so.

15 One of Grid's key submissions here appeared to be, and this is what we have said is a new
16 point that is not actually in the notice of appeal, but leaving that to one side for the moment,
17 the point really is that replacing a working meter is inefficient. So, if you have an
18 arrangement that sets up disincentives to replacing a working meter, then that is efficient –
19 this is the ownership analogy – and therefore, by definition, cannot be foreclosing. Of
20 course, we do very much take issue with that proposition because competition law is, after
21 all, about ensuring or seeking to ensure an efficient outcome through the process of
22 competition, not through the application of some *a priori* model.

23 So Grid cannot simply say, "Well, not efficient to replace the working meter. That is what
24 the MSAs really achieve by way of incentives. Therefore, they were absolutely fine in
25 competition law terms. If that were right, then one can imagine someone who has sunk its
26 costs incredibly inefficiently and would yet say, "We're entitled to recover them in this way
27 and as long as there are dis-incentives to replacing a working meter, that is absolutely fine,
28 and it does not matter how long the arrangement is, or how foreclosing it actually is in its
29 effect".

30 That really is our case in a nutshell.

31 Turning then to the different parts of the case - and, of course, market definition first of all -
32 as we pointed out in our skeleton at para. 13, Grid has not dealt in its skeleton with the issue
33 of geographic market at all. I certainly understood Mr. Turner now to be really accepting
34 that that is not an issue for us. So, I will not trouble you with any submissions on that.

1 So far as the principles of market definition are concerned, of course, they are well-
2 established, but particularly as Mr. Turner did, I think, accuse us yesterday of
3 misunderstanding at least an aspect of it, it may be useful if you just remind yourselves of
4 the key bits in the Commission's Notice on this which you have at A1, Tab 22. First, we
5 have para. 7 on p.2 of this print-out, which I would just remind you says,

6 "Relevant product markets defined as follows: 'A relevant product market
7 comprises all those products and/or services which are regarded as
8 interchangeable or substitutable by the consumer, by reason of the products'
9 characteristics, their prices and their intended use'"

10 If we then go to the heading 'Basic Principles for Market Definition' and para. 13,

11 "Firms are subject to three main sources of competitive constraints: demand
12 substitutability, supply substitutability and potential competition. From an
13 economic point of view, for the definition of the relevant market, demand
14 substitution constitutes the most immediate and effective disciplinary force on the
15 suppliers of a given product --"

16 That is really the bit that we would emphasise - the primacy, as it were, given to demand
17 side substitution. Just to complete the picture on the law here, can I take you very briefly to
18 this Tribunal's Decision in Aberdeen Journals which you have at Authorities Volume 2, Tab
19 41 at paras. 96 and 97 at p.1116.

20 "96. The foregoing cases indicate that the relevant product market is t be defined
21 by reference to the facts in any given case, taking into account the whole
22 economic context, which may include notably (i) the objective characteristics of
23 the products; (ii) the degree of substitutability or interchangeability between the
24 products, having regard to their relative prices and intended use; (iii) the
25 competitive conditions; (iv) the structure of the supply and demand; and (v) the
26 attitudes of consumers and users.

27 97. However, this checklist is neither fixed, nor exhaustive, nor is every element
28 mentioned in the case law necessarily mandatory in every case. Each case will
29 depend on its own facts, and it is necessary to examine the particular
30 circumstances in order to answer what, at the end of the day, are relatively
31 straightforward questions: do the products concerned sufficiently compete with
32 each other to be sensibly regarded as being in the same market? Are there other
33 products which should be regarded as competing in the same market? The key
34 idea is that of a competitive constraint: do the other products alleged to form part

1 of the same market act as a competitive constraint on the conduct of the allegedly
2 dominant firm?"

3 Now, applying that approach in this case we make two straightforward points. First, it is
4 clear that new and replacement meters which, of course, include the meters supplied by the
5 CMOs are demand side substitutes for Legacy meters, and that, of course, as I said, was a
6 particular concern for Grid in this case. As Mr. Turner accepted yesterday, new and
7 replacement meters do provide a competitive constraint on Legacy meters - again, the whole
8 point of Grid's concerns.

9 That is not a question of misguidedly looking at potential competition at this stage contrary
10 to the Commission's Notice. It is looking, as I said, (a) at demand side substitutability and
11 (b) at actual constraint, actual competition being provided by new and replacement meters.
12 So, we have not fallen into the error that we were accused of.

13 It may be sensible for you to remind yourselves of how we deal with this in the decision at
14 this point (p.45 of CB1, the external numbering. Paragraphs 3.13 to 3.14, particularly at
15 para. 3.14. One sees at 3.14 that, of course, the Authority here refers to Grid's argument
16 about different conditions of competition, but then crucially concludes,

17 "Nevertheless, it is clear that, by their very nature, N/R meters are very good
18 demand side substitutes for Legacy meters from a gas customer or supplier
19 perspective and that they provide a competitive constraint on Legacy meters".

20 That is really the crucial conclusion which, in our submission, cannot be faulted. Now,
21 Grid has accused us - not really in oral submissions, but in their skeleton - of paying too
22 much, or even exclusive attention to the intended use and physical characteristics of a
23 meter. But, as I hope that this passage has shown you, we have not done that. In fact, we
24 have quite properly applied the relevant criteria as set out inter alia in the Commission's
25 Notice. Now, of course, intended use and physical characteristics are important, and we
26 have taken those into account - but by no means exclusively.

27 As then to different competitive conditions, as I have said, the Authority mentioned that in
28 para. 3.14 but did not consider it sufficient to change the ultimate conclusion, and the
29 fundamental problem with Grid's contention here is it really focuses on the perspective of
30 Grid itself entirely. It looks at the fact that Grid has sunk its costs, but that is to the
31 exclusion of looking at how it appears from the perspective of the gas supplier, and indeed
32 ultimate customers but gas suppliers, for whom, as I said, new and replacement meters were
33 very good substitutes indeed.

1 I have talked about Legacy Meters and new and replacement meters as though it were
2 absolutely clear what the distinction is, but there have been different definitions of that
3 distinction in the course of the case. I really mean Legacy Meters being those that were
4 installed at the time and cost sunk at the time when the Legacy MSA was signed, or were
5 signed, and then contrasted to other meters that were installed thereafter. But in fact, that is
6 not the definition that Grid has used, certainly not always. They kicked off with a definition
7 that was simply taken from the Legacy MSA, i.e. referring to the date of 1st January, all
8 meters installed before that date were Legacy Meters – any meters installed thereafter were
9 not. But if that was meant really to refer to whether meters had been installed when the
10 Legacy MSAs were agreed then of course it did not work because most of the suppliers
11 actually signed the Legacy MSAs after 1st January.

12 Having said that, Dr. Williams as we understand it then in his second report made it clear
13 that no, it was not a question of simply using the date in the Legacy MSA but it was actually
14 looking at whether costs were sunk at the date when the agreement was signed, whenever
15 that was. Yesterday we seemed to get a further definition from Mr. Turner when he actually
16 said “Any meter, as soon as it is installed and the costs are sunk it becomes a Legacy
17 Meter”. Well that, with great respect, as a definition we say does not make an awful lot of
18 sense in the context of how Grid have otherwise put their case, not least looking at the table
19 of market shares that they have referred to, you will recall at the notice of appeal para. 263,
20 core bundle 1, p.248. It may be worth going back to that to remind ourselves. Page 248,
21 where of course Grid would point to that table of new and replacement meters installed in
22 the different years and would say that this shows very healthy entry by the CMOs and lack
23 of dominance and so forth, well that really does not make sense if you adopt Mr. Turner’s
24 definition of “legacy” and “New/Replacement” meters yesterday. To be fair, I think,
25 judging by one of the notes that were handed up today Grid have now actually gone back to
26 the definition that was adopted by Dr. Williams, when he said it is all about whether costs
27 were sunk at the date when the Legacy MSAs were signed. That is how I understand the
28 position.

29 Now, may I flag, if we need to, we will perhaps – and I hope we will be permitted to –
30 respond to Grid’s various written notes in writing ourselves.

31 Leaving that difficulty of definition to one side we can just come back to that fundamental
32 point about new and replacement meters being demand side substitutes and actual
33 competitive constraints, as well as, of course, being physically the same, and in terms of
34 their intended use.

1 It may be that Mr. Turner's real concern here was that in this case the very large market
2 share simply does not indicate dominance; I think he said that yesterday, in the context of
3 looking at market definition. If that is the real concern, then really the argument should take
4 place within the context of the issue of dominance, but it is not a reason to define market in
5 a way that is very artificial, which is what we would suggest Grid have sought to do.

6 I should perhaps just mention another point that Mr. Turner did not refer to, but it is
7 certainly contained in Grid's expert evidence, Dr. Williams again, it is his second report
8 where he refers to three Commission Decisions concerning truck tyres and automotive
9 products. You have them in bundle A6, but I do not actually propose to ask you to look at
10 them now, but just to make our key point about them, which is they were really designed to
11 prove that we were wrong to say that products which share identical characteristics and
12 usage may never be in separate product markets, and all I would flag up is that that was not
13 (and is not) our case and we entirely accept that those Commission decisions are examples
14 of products with identical characteristics and uses that were held to be in different product
15 markets really there, because of different consumer groups.

16 Very briefly, so far as supply side substitution is concerned, we did not really feature again
17 in Mr. Turner's oral submissions but it does remain in Grid's skeleton so I should perhaps
18 just explain our position. We have said that electricity meters are not supply side substitutes
19 for new and replacement meters and they are not therefore part of the same product market
20 (Decision paras.3.3 to 3.39). It appears that Grid is saying "Ah, no, but actually they are
21 supply side substitutes" if you focus on the new and replacement market as they see it.
22 That, of course, assumes at this point the very thing that remains in issue, i.e. that there is a
23 separate market for new and replacement meters.

24 We, of course, have said single market and on that basis we have said the electricity
25 suppliers do not provide supply side substitution in any relevant sense and there is no
26 challenge to that view, so far as I can make out.

27 THE CHAIRMAN: There is a distinction though, your submissions so far have all been in terms
28 of meters rather than the metering service, which is I think what you found that the relevant
29 product market was, not the market for the meters, but the market for the metering service.

30 MISS CARSS-FRISK: The relevant service, yes.

31 THE CHAIRMAN: Now as far as the supply substitutability is concerned I can see that an
32 electricity meter is not a substitute for a gas meter, and it may be difficult for people who
33 make electricity meters to change to making gas meters in terms of production of the item,
34 but are we not here more concerned with the ability of people who provide electricity

1 metering services to enter the market for gas metering services, which they can do (as these
2 have) by buying electricity meters?

3 MISS CARSS-FRISK: As it seems to us we are really concerned with the package; we are
4 concerned with the provision of meter and attendant services where the Authority has
5 found, as I said, that the electricity meter providers in fact are not able to provide a
6 competitive constraint for these purposes; it is really the package we are concerned with
7 and, as I say, I do not understand there to be a challenge to that if we are concerned with the
8 single market looking at Legacy and new and replacement meters together, which is of
9 course the finding that we have made.

10 Just picking up one other point on supply side substitution, this relates to Grid saying in
11 their skeleton argument that there are limits to the contestable market and you may need
12 here just to open Grid's skeleton argument briefly, which is core bundle 2, p.863. It is
13 Grid's skeleton, para.23(a), where they say:

14 "Ofgem is also mistaken in denying the relevance of supply side substitution from
15 electricity meter providers in assessing the (differing) competitive conditions
16 applicable to the supply of new and replacement and Legacy Meters.

17 a. The contestable gas metering market for N/R business is, naturally, not
18 equivalent to the size of the entire installed base of Legacy Meters. Once Meters
19 are installed, where normal and efficient replacement incentives apply, they will
20 not be replaced except in the case of failure/inaccuracy, where a functionality
21 exchange is required, or if a new Meter offers some incremental benefit sufficient
22 to justify sinking the installation costs afresh. There is therefore no basis for
23 Ofgem to dismiss supply side constraints from the CMOs on the basis that, whilst
24 they have entered the market relatively quickly, *'they have not established*
25 *sufficient scale to act as an effective competitive constraint on NG given NG's very*
26 *high market share and installed meter base'.*"

27 All I would pick up here is that reference to the size of the contestable market where normal
28 and efficient replacement incentives apply. This argument then really assumes that you
29 have a market where there are cancellation charges which, on Grid's argument, would
30 provide normal and efficient replacement incentives. Of course, that is very much in issue
31 and would be the product of the Legacy MSAs, and in any event the key point for looking at
32 this is surely the time before the entering into of the Legacy MSAs when, in fact, clearly
33 Grid did not have in place arrangements that provided for what Grid would call our efficient

1 replacement incentives. On that basis, the contestable market would actually not be cut
2 down in the way that Grid has suggested. So that is the response to that point.
3 That really completes what we would say about market definition.
4 Turning then to the question of dominance, we rely on three key matters to show
5 dominance, as Mr. Turner rightly identified yesterday, firstly, Grid's extremely large market
6 share, secondly, barriers to entry, and thirdly, the lack of sufficient countervailing buyer
7 power. We have said that Grid has not challenged our case on dominance if we are right in
8 our definition of "one single market" here, and that Grid, in fact, has chosen to address this
9 really on the assumption, and only on the assumption, that it is right that there are two
10 separate markets. Yesterday I know Mr. Turner said, "No, no, that is not correct", but, to be
11 frank, is not clear to us on what basis he says we are wrong here. If one looks at the notice
12 of appeal – and for your note it is a very long section – paras.260-380, one does see, in our
13 submission, that Grid has chosen to deal with this matter separately for new and
14 replacement meters where they deal with market share and barriers to entry, and then
15 separately for Legacy meters where they focus on countervailing buyer power.
16 In case this point may be important, can I just remind you of the concluding section of this
17 part of the notice of appeal. It is core bundle 1, p.285, starting at para.378:

18 "Ofgem's case that National Grid was (or remains) in a position of dominance in
19 an overall market for the provision of Meters (both Legacy and N/R Meters) is
20 misconceived. It is based on a flawed analysis, since the position in relation to
21 Legacy Meters and N/R Meters requires to be addressed separately.

22 There is no solid basis for Ofgem's finding that National Grid is in a dominant
23 position in relation to the provision of N/R Meters. Nor is there any solid basis for
24 Ofgem's finding that National Grid was in a position of dominance vis-à-vis the
25 major gas suppliers in relation to the negotiation of the Legacy deal in 2002/2003."

26 So in that summary, as it seems to us, one really gets Grid's approach, "Well, you just
27 cannot look at one single market and so we are going to look at it in terms of two separate
28 ones". We pointed this out in our defence at paras.114-115, and Grid has not actually
29 sought to disagree until yesterday. They did not say in their skeleton that we were
30 completely wrong about this.

31 So there we are, we really just invite you to take our submissions on this against that
32 background. In a sense, they may not be relevant at all if we are right on this point.

33 Looking first at market share, and on Grid's suggested assumption that there was a separate
34 market for new and replacement meters, we do say that considering the table in the notice of

1 appeal that we have already looked at today, but perhaps you can have it open again,
2 para.263 of the notice of appeal, p.248. If one looks at that table again and if we are right
3 that you can consider Grid and UMS together for these purposes, then of course one sees
4 that Grid actually has installed over 60 per cent of the new and replacement meters between
5 2005 and 2007.

6 Grid, I think, would say that we are not entitled to make this point, but really it arises only
7 by way of response to their point that one needs to focus on two separate markets here,
8 which argument of course is not based on the finding in our Decision, which was of a single
9 market.

10 The other response, the substantive response, that Grid makes is that it is not permissible to
11 look at UMS and National Grid metering as one undertaking here. We say it is on well
12 established principles, because here we have National Grid Plc controlling both UMS and
13 National Grid metering. It is the ultimate parent company controlling both, and they are all,
14 therefore, part, we say, of one undertaking. We have cited the case of *Viho Europe* in this
15 context, which it may be useful for the Tribunal to remind itself of. It is Authorities bundle
16 1, tab 18. It is paras.15 to 17 on p.7 of the print-out:

17 “It should be noted, first of all, that it is established that Parker holds 100% of the
18 shares of its subsidiaries in Germany, Belgium, Spain and the Netherlands and that
19 the sales and marketing activities of its subsidiaries are directed by an area team
20 appointed by the parent company and which controls, in particular, sales targets,
21 gross margins, sales costs, cash flow and stocks. The area team also lays down the
22 range of products to be sold, monitors advertising and issues directives concerning
23 prices and discounts.

24 Parker and its subsidiaries thus form a single economic unit within which the
25 subsidiaries do not enjoy real autonomy in determining their course of action in the
26 market, but carry out the instructions issued to them by the parent company
27 controlling them.

28 In those circumstances, the fact that Parker’s policy of referral, which consists
29 essentially in dividing various national markets between its subsidiaries, might
30 produce effects outside the ambit of the Parker group which are capable of
31 affecting the competitive position of third parties cannot make Article 85(1)
32 applicable, even when it is read in conjunction with Article 2 and Article 3(c) and
33 (g) of the Treaty. On the other hand, such unilateral conduct could fall under

1 Article 86 if the conditions for its application, as laid down in that Article were
2 fulfilled”.

3 So, we, of course, home in on the reference to group companies forming a single economic
4 unit. It is not just the fact that they are part of the same corporate structure, but it is also a
5 question of them being under the same strategic control as Grid itself has accepted.

6 THE CHAIRMAN: That is the curious thing - that there is market share both for UMS and for
7 National Grid. Now, I am not sure whether there is enough track record to be able to say
8 what happens when people invite tenders. Do both National Grid and UMS put in
9 competing tenders or does only one of them compete? How does it work? (After a pause):
10 It may not be a question that you can answer. I just wonder whether there is something
11 different in nature in the business that National Grid gets and the business that UMS gets
12 that leads to this slightly curious ----

13 MISS CARSS-FRISK: It is true that there is the bidding markets issue, which I was going to
14 come on to that Grid has referred to - that UMS, together with the CMOs, did engage, in a
15 sense, in bidding through competitive tender, as it were. But, of course, one point we make
16 here, apart from some other points about bidding markets, is that clearly we would say
17 UMS could be expected to derive some advantage from its connection to National Grid in
18 terms of Grid’s presence, reputation, experience, know-how, etc. in the market. So, the fact
19 it is true that UMS would be appointed in a different way does not, in our submission, mean
20 that they are not part of the same commercial undertaking for these purposes, and does not
21 mean that it is wrong to group them together in assessing dominance - of course, assuming
22 that we are looking at new and replacement as a separate market.

23 THE CHAIRMAN: So, the 38 percent there for 2005 - does that relate to meters that go on to the
24 new and replacement National Grid contract?

25 MISS CARSS-FRISK: Yes.

26 THE CHAIRMAN: Whereas the UMS ones are subject to some different contract?

27 MISS CARSS-FRISK: That is right. Effectively, UMS deal on CMO terms. So, they are, in that
28 sense, to be grouped together with the CMOs. However, for the purposes of, “Are they part
29 of the same commercial undertaking?”, they are.

30 THE CHAIRMAN: Yes.

31 MISS CARSS-FRISK: I was going to show you in that context what Grid itself had said in
32 answer to questions from Ofgem about this topic. It is at PD3, Tab 39. There you have
33 Grid’s answer at p.1722, dated 1st August, 2007. If you go to p.1729 you have the heading
34 ‘Status of UMS’. Question 7:

1 “Please explain why you consider it reasonable to include UMS, the wholly
2 owned subsidiary of National Grid, as a new entrant when considering the pace of
3 development of competition and success of new entrants in providing new and
4 replacement meters”.

5 What they say is,

6 “We refer to Duncan Sinclair’s e-mail of 27th July, 2007, in which he provided
7 clarification of the issue of concern to the Authority”.

8 There is then a reference to Mr. Sinclair having said in the penultimate sentence in para. 1,

9 “For the avoidance of doubt, our position is that as a matter of law all parts of the
10 group ought to be treated as a single undertaking”.

11 Now, Grid’s answer then at para. 2 is,

12 “There are two separate questions which should be disentangled. The first is
13 whether UMS should be considered a separate undertaking from National Grid
14 Metering in terms of the overall strategic control and direction of National Grid’s
15 business as a whole. So far as that is concerned, the answer is ‘No’. The second
16 question is whether, in accordance with the Authority’s question here, the example
17 of UMS casts any light on the pace of development of competition and success of
18 new entrants in providing new and replacement meters. In our submission, it
19 plainly does so, given the special features of the relationship between NGM and
20 UMS, and indeed the Authority’s own Statements of Objection rightly proceed on
21 this basis. For that reason, when examining the gains achieved by new entrants in
22 the face of the MSAs, it is right to include the market share of UMS”.

23 If you then go to para. 3,

24 “The Authority is concerned, in this investigation, with whether features of the
25 MSAs (to which NGM is a party) foreclose the market to other CMOs. It is
26 reasonable to include UMS as a new entrant in this context, even though it is a
27 wholly owned subsidiary of National Grid. This is because:

28 (a) In competition law, the term ‘undertaking’ means a single economic unit for
29 the purposes of the subject-matter of the agreement (or conduct) in question.

30 Where one is dealing with two or more subsidiaries, it is relevant to ascertain
31 whether those subsidiaries belong to a single economic unit within which the
32 subsidiaries do not enjoy real autonomy in determining their course of action in
33 the market.

1 (b) In the present case [and this is really the significant passage] , UMS is run at
2 an operational level independently of NGM, for regulatory reasons. Each has its
3 own management structure with separate Business Operations Directors and
4 finance managers. Its contracts are negotiated separately and each makes its own
5 arrangements for its workforce. The two companies do share a Managing Director
6 but his function is to manage the strategy and performance of metering in National
7 Grid: the more traditional Managing Director's role is carried out by each
8 company's separate Business Operations Director. The only other functions that
9 are shared are human resources, health and safety and IS/change management".

10 THE CHAIRMAN: Does UMS only relate to British Gas?

11 MR. TURNER: Madam, no. It is the company, as my learned friend rightly says, which is the
12 tendering entity, and which tenders on the same terms as the other CMOs. It does tender for
13 work other than that for British Gas. In the passage I took you to this morning about new
14 developments you will see that one of the gas suppliers - I think it was SSE - has recently
15 awarded new work, and it has awarded it both to UMS and to Scotia.

16 THE CHAIRMAN: But at the time of the Decision was all UMS' work with British Gas?

17 MR. TURNER: At the time of the Decision, yes. There were what may come up later in the case,
18 these churn contracts. So, it starts with British Gas, but if the householder moves to another
19 gas supplier, such as Npower, who then takes over the household, then they have to
20 establish a relationship with the new gas supplier. Those are the so-called churn contracts.
21 UMS, like the other CMOs, has churn contracts with other gas suppliers.

22 THE CHAIRMAN: It may be that this will become clear as we go along.

23 MISS CARSS-FRISK: I think Mr. Turner has confirmed what I understood to be the position,
24 which is that at the time of the MSAs and at the time of the Decision, UMS had in fact only
25 obtained work from British Gas, but subject to these churn contracts which were referred to.
26 But, we are told that there has been a recent development thereafter.

27 THE CHAIRMAN: Yes, so the National Grid contracts are then with the meters that are referred
28 to as there are with the other gas suppliers, and in the other British Gas areas ----

29 MISS CARSS-FRISK: I am so sorry, madam, I was being offered some instructions.

30 THE CHAIRMAN: That is all right.

31 MISS CARSS-FRISK: May I possibly ask you to repeat the question?

32 THE CHAIRMAN: It is unfair to press you on this but I think it would be useful at some stage to
33 have some idea as to how it comes about that a new meter is replaced by National Grid

1 rather than UMS or by UMS rather than National Grid, so we can understand a little bit as
2 to how this split comes about.

3 MISS CARSS-FRISK: We can certainly seek to obtain further detail on that but, as I understand
4 it, that is simply by bilateral agreement, but not through the tendering process unless it is
5 part of a meter being replaced in connection with maintenance as we have seen, and then
6 you have the link between the Legacy MSA and the new and replacement MSA, but if I can
7 obtain further elaboration on that I certainly will.

8 THE CHAIRMAN: Thank you.

9 MISS CARSS-FRISK: Now just to complete the point we were making here, having highlighted
10 how the two entities shared a managing director, and also various other teams, perhaps I can
11 just give you the reference: Mr. Shoesmith of National Grid in his second statement at
12 para.6 also refers specifically to a strategy team that was shared between these two entities.
13 So all of this, we would say, providing powerful support for the idea of one business unit
14 for relevant purposes. And, of course, one should not forget that, as is recorded in the
15 Decision – this is paras.3.91 to 3.93 – National Grid Gas senior management, when
16 negotiating the MSAs did link that deal and work being provided to UMS (the UMS deal)
17 so again underlining, we would say, how the two businesses were part of the same unit.
18 This much is accepted by Grid (see notice of appeal, para.362). It is true that Grid also
19 signalled to gas suppliers and investors that it had the intention to consolidate National Grid
20 metering and UMS into one company (see Decision, para.2.37) and, as I understand it, that
21 is still advertised as the intention on Grid’s website. I am told yes, although I can see that
22 Mr. Turner is dying to jump up and offer an objection.

23 THE CHAIRMAN: If it turns out to be relevant we may need to pursue it further.

24 MISS CARSS-FRISK: Grid, of course, say here: “Well, Ofgem you are being inconsistent”, I
25 think Mr. Turner may have said we are trying to ride two horses at the same time, because
26 we are saying that in order to assess dominance, applying the legal test, you have one single
27 undertaking here which shows a more than 50 per cent market share, but then “At the same
28 time”, says Mr. Turner, “you are relying on what happened to the meter replacement
29 volumes of UMS to show that they were reduced because of the legacy MSAs and how is
30 that consistent. Well we say “perfectly consistent; only one horse in fact”, one is applying
31 the legal test of dominance, and the other is simply saying: “Let us look at the effect that the
32 Legacy MSAs are having”. To judge that it really does not matter whether UMS is part of
33 the same undertaking legally or not as Grid, it is simply a question of saying: “The Legacy

1 MSAs had this effect, that UMS's volumes needed to be reduced in order to cater for the
2 glidepath allowance. That much I do not think is actually in dispute.
3 As for this argument then about competitive bidding playing a role here, I do not think Mr.
4 Turner particularly picked that up orally yesterday, but it is in Grid's skeleton para.25(d)
5 and 26(d). The argument, as we understand it is, again focusing now exclusively on new
6 and replacement meters, there was a bidding market and that was sufficient to displace any
7 presumption of dominance. We would say "Hold on a minute", if you look at what
8 happened, UMS was awarded four out of the seven British Gas regions and, as I have
9 already suggested, UMS would have had – even in that process – a considerable advantage
10 through its association with Grid, to put it neutrally in that sense. In any event, we would
11 say there do appear to be doubts as to whether bidding markets really make such a big
12 difference in this context. Here we referred to an article by Mr. Paul Klemperer, which you
13 have at Authorities' bundle 6, tab 15, called "Bidding markets". If we look at p.1 of the
14 print out, and I am only going to refer to some very short passages, under the heading
15 "Introduction" the third paragraph down:

16 "Three distinct strands of thought seem to lie behind the widespread view that
17 antitrust can safely ignore markets conducted through bidding processes. First are
18 the claims, heavily pushed by legal and economic consulting firms, that in
19 "bidding markets", market share does not imply market power, that the existence
20 of two firms is enough to imply perfect competition, or even that just one firm is
21 enough."

22 Then I would just jump to the next paragraph that says:

23 "This paper explores and – I hope – explodes, these myths."

24 I would not dream of trying to persuade you that Mr. Klemperer's view is inevitably the one
25 and only view in this field, but I would suggest that at the very least it casts doubt on Grid's
26 argument that we are concerned with bidding so all is fine and dandy and there is no
27 question of dominance.

28 THE CHAIRMAN: It is not so much a question of bidding, it is a question of how quickly the
29 market share is going to be eroded over time, and what that shows. Suppose that National
30 Grid had decided they were going to exit this market, they would deal with the Legacy
31 meters, but they were not going to go into the business of replacing them, and gradually
32 they would then be replaced, or quickly they would be replaced, so that this table here
33 would just show other people's market entry. Now, it may take some time before their
34 market share comes down from the 98 per cent, whatever they start with, or the 100 per cent

1 they start with, before it comes down to below 50 per cent, but what does that tell us about
2 their market power? I suppose here we are talking about the market power in relation to the
3 deal they struck for those Legacy meters which they are still dealing with.

4 MISS CARSS-FRISK: Well it certainly tells us, in our submission, that there are considerable
5 barriers to entry by the sheer logistics of the matter for anyone who wants to come into the
6 market, simply because Grid sits there on its vast installed legacy base. That is one point.
7 But, of course, we are then looking at, in a sense, the single market that includes the Legacy
8 meters that we have defined where, in fact, I would just remind you that Grid's argument
9 about bidding markets, as I understand it, is actually confined to what they would see as the
10 new and replacement meter market. It is only within the confines of that sector, to use a
11 neutral word, that there is any sort of bidding.

12 THE CHAIRMAN: And also the volumes are insignificant when you compare them to the
13 overall stock, but are significant when you compare them to the total new and replacement
14 meters.

15 MISS CARSS-FRISK: Precisely. That indeed would be our point. The other point we make
16 here is that because you have the relationship between the Legacy MSAs and meters being
17 replaced in connection with maintenance and then automatically going on Grid's new and
18 replacement contracts, you do, of course, have what Mr. Klemperer – I say “of course” –
19 refers to as a “lock-in”, in the sense that the outcome of one contest, i.e. the making of the
20 Legacy MSA, actually has a determining effect on another, i.e. translating that, results in
21 meters actually automatically being replaced and going on the new and replacement
22 agreement. That is another reason we have cited in our skeleton as to why the bidding
23 markets' argument does not really help Grid.

24 Just to pick up the reference in Mr. Klemperer's article – p.2 of the print-out – what one
25 needs to look at is just above the middle of the page, the heading A “(Ideal) ‘Bidding
26 Markets’”, and the third paragraph under that heading:

27 “Although it can be debated whether the European Commission actually intended
28 this to be a general definition of a ‘bidding market’, this is certainly a common
29 interpretation. That is, the term is associated with contests where ...

30 3. ‘Competition begins afresh for each contract, and for each customer’. That is, if
31 there is any repetition of a contest, there is no ‘lock-in’, by which the outcome of
32 one contest importantly determines another.”

33 That is where we get that reference from.

1 I am helpfully told by Mr. Kennelly that I should tell you that in our skeleton we refer to a
2 different print-out of the article, so we have cited different page references for
3 Mr. Klemperer. I think we have cited p.6 and p.4, when in fact you have seen on this print-
4 out it is pp.1 and 2.

5 Turning then to barriers to entry and expansion, you may want to remind yourselves of
6 para.3.68 of the Decision, which I know you were invited to go to yesterday. You have the
7 whole section on barriers to entry and expansion starting at p.56, para.3.66, but then really
8 the reasoning at 3.68, making this point that, of course, it is important to have economies of
9 scale, density is important, and the gas meter has characteristics which makes entry and
10 expansion on a significant scale difficult in a short space of time, not least because of the
11 practical logistics of buying and installing a large number of meters, and one should factor
12 in here the need to have a competent workforce to deal with all that, all of which we would
13 suggest very clearly gives Grid a huge advantage, certainly in the broader market that we
14 have defined.

15 Mr. Turner said, or certainly his skeleton said, there is no evidence or analysis for any of
16 this really, and he said, “Where is the competitive advantage for Grid, where is it?” I think
17 he was focusing there on his narrower market of new and replacement meters only. We say
18 that as far as that is concerned, you do have a perfectly reasonable reference to what we are
19 talking about at para.3.74 of the Decision, which makes this point about the need for
20 economies of scale and density, and says at the end:

21 “This gives NG a significant advantage in carrying out new and replacement
22 work.”

23 I think you were taken yesterday to the footnote 222, which refers to how:

24 “... the legacy business has some fixed costs and therefore a higher number of
25 meters would lead to a lower unit cost so supporting a platform for growth in the
26 future.”

27 Even forgetting the Legacy meters in a sense, we would say fairly clearly Grid will have
28 advantages just in relation to the new and replacement work because it has its established
29 network systems, workforce, and so forth. Of course, it can also get the density through
30 combining replacement with maintenance work. In our submission, there really is not
31 much, frankly, in Grid’s complaint here. Even on their definition of the market, there are
32 barriers to entry.

33 Turning then to countervailing buyer power, which of course is particularly important in
34 relation to the legacy side of the market, the test I do not think is disputed. It is, of course,

1 *Hoffmann-La Roche*, and one looks at whether the allegedly dominant undertaking can
2 behave to an appreciable extent independently of its competitors' customers and ultimately
3 consumers. We do stress that phrase to an appreciable extent. What that translates into is
4 that an undertaking may, of course, be dominant even if there is some countervailing buyer
5 power, so long as that power is not sufficient to negate the power of the dominant
6 undertaking. Contrary to what Grid has at least at times suggested, we have always
7 accepted that there was some countervailing buyer power, certainly in British Gas in this
8 case, but the point is that it was not sufficient. Grid would remain a 'must deal' partner for
9 a number of years. Even on British Gas's own most optimistic assessment as to how
10 quickly it can switch out the meters, which was eight years – that is all of them ----

11 THE CHAIRMAN: Do you say it is a 'must deal' partner not just in relation to the installed
12 meters, but in relation to new and replacement meters, that it would be difficult for a
13 supplier to decide to have all its new and replacement meters with somebody other than
14 National Grid?

15 MISS CARSS-FRISK: I do not think that is how we put it in the Decision, but I can certainly see
16 the point that that would be difficult simply because of the practicalities of the situation, the
17 difficulties of entry, which meant that there simply were not many CMOs to choose from,
18 and there were those logistical difficulties anyhow.

19 There is also indeed, I was going to come on to, the issue of maintenance replacements that
20 we come back to where the 'must deal' aspect of the contract, i.e. the Legacy MSA,
21 between Grid and British Gas, would then also result in, as it were, a 'must deal'
22 arrangement, which is the new and replacement agreement.

23 In this context, Mr. Turner of course referred to the new Commission guidance that came
24 out in early December that you have at Authorities bundle 6, tab 20, which perhaps you
25 should have it open just for completeness. Mr. Turner highlighted para.11, among others,
26 and he referred to whether an undertaking is able to set its prices above the competitive
27 level. The first point we would make is that that is no doubt one criterion by which you
28 assess dominance, but not the only one. But, the second point is that Grid was able to set its
29 prices above the competitive level in the Legacy MSAs because you cannot assume that the
30 P&M terms - the terms with the price cap - represented the competitive level here. You
31 have to of course look at the prices being offered by the CMOs. There is no dispute that the
32 Legacy MSA prices were higher than those.

33 MR. TURNER: Madam, just for the record - I am not standing up whenever it is said there is no
34 dispute, there is no challenge, but take it as read that it is not always accepted.

1 MISS CARSS-FRISK: I am not sure if I should take it that this particular point was not accepted
2 or just every ----

3 MR. TURNER: You can take it that this particular point is not accepted.

4 THE CHAIRMAN: Just remind me what the point was?

5 MISS CARSS-FRISK: The point was that Grid was actually able to set prices, or to achieve
6 prices above the competitive level because you cannot assume that P&M prices represent
7 the competitive level. You have to factor into the analysis that there was a significant
8 difference in price between the rentals in the Legacy MSAs and the rentals offered by the
9 CMOs. That is so even after, as we will see in due course, you make every allowance for
10 Grid's various complaints about our price comparisons which you may have seen in various
11 supplementary submissions. But, making every allowance, we say the fact is that there was
12 a significant difference. So, not able to set above the competitive level.

13 In a sense, that also provides the answer to a slightly different point that Grid has made,
14 which is, "Well, even if, in a sense, Grid was a 'must deal' partner, the Legacy MSAs were
15 not 'must deal' terms because you had the alternative of the P&M terms". That is not really
16 much of an alternative in the sense that those prices, as I have said, were above the
17 competitive levels, we would suggest. Then, of course, we have the point which I think you,
18 Madam Chairman, made earlier about Grid sitting there with this vast installed base of
19 meter, being able to offer an across-the-board reduction which it may well be that the gas
20 suppliers and British Gas in particular was content to take up at the end of the day. But,
21 none of that suggests that Grid was not dominant or undermines the fundamental indications
22 of dominance in this case.

23 Of course, one must bear in mind here the nature of the price reduction. In a sense, what
24 you have here is British Gas taking over Grid's risk and getting what you might call a price
25 reduction in return. But, to what extent is it really properly a price reduction? It is transfer
26 of risk through the PRCs. I am not suggesting this whole case should turn on whether it is
27 properly a price reduction or not. But, it is right to note, we would suggest that that is the
28 bargain - this transfer of risk.

29 THE CHAIRMAN: That is why we explored a little bit yesterday to what extent that risk was
30 factored into the price cap set by Ofgem, which they continued in the P&M contract. I
31 think what Mr. Turner was saying is that there was some amount factored in, but actually it
32 was smaller than National Grid would have liked.

33 MISS CARSS-FRISK: It is certainly right that it was factored into the price cap. Mr. Stephen
34 Smith deals with that in particular. Of course, we have been told that his evidence is not

1 going to be challenged. So, I would refer you to that. He powerfully makes the point that
2 there was a very helpful adjustment, shall we say, to Grid in relation to the price cut,
3 particularly looking at cost of capital. But, it is agreed that it was looking to deal with this
4 in part. It was, of course, something that Grid accepted at the time. They did not seek to
5 challenge the price control as they could have done. One of the things - that I think I can
6 say without giving evidence - which has puzzled the Authority is that Grid accepted that on
7 the one hand and then comes back and says, "Oh dear! We have all these potentially
8 stranded assets and sunk costs. Now we want to re-open the price cap issue to see if we can
9 get more" when one might have thought that when the cap was originally set and an
10 allowance was made for that, that they might have raised the point then. But, anyhow, that
11 is what happened. Then, of course, as you have seen, after a while the idea emerged of
12 dealing with it through commercial negotiations instead. So, the answer to your question is,
13 "Yes, a part of the risk had been allowed for, but Grid were not content with that".

14 Just for your reference, it is Mr. Smith's witness statement at paras. 43 to 50.

15 The final point I wanted to make here about P&M terms and the role they play is that we do
16 stand by our much-criticised submission that there was an element of uncertainty for the gas
17 suppliers here in that they had the choice, yes, of remaining on the P&M terms as EDF did,
18 but they could not be certain that prices might not actually go up after the cap had been
19 lifted. Now, we know that Ofgem had said, "We intend to lift the cap when competition is
20 established" as they hoped it would be. Grid says now, "Well, of course, the price would
21 not have gone up once competition had been established". We say simply, "Well, there is
22 no guarantee of that" One would have had to have seen what actually happened, assuming
23 that there was competition in the market and the cap had been lifted. It may be that Grid
24 would have taken advantage of what I think Mr. Turner referred to as 'inertia' in the hope
25 that it would hang on to a sufficient number of supplier customers in relation to a sufficient
26 number of meters for it to be sensible to raise its prices. But, this is all speculative. That is
27 the whole point - that there was a speculative element there.

28 THE CHAIRMAN: Is there anything in the board papers that we have been shown some of
29 which indicates that that was a factor which any of the gas suppliers took into account?

30 MISS CARSS-FRISK: No, madam. I do not believe that there is. I think the highest I can put it
31 - and, to be fair, the highest the Authority has put it - is that this is a factor that was
32 objectively present. But, I cannot say, "And here is a sentence that says, "We were much
33 influenced by this point".

1 As for the way the negotiations went with the suppliers then - and, of course, British Gas in
2 particular - Grid has complained that this was not properly analysed in the Decision. We
3 are a little puzzled by that because if you look at paras. 3.75 to 3.98 in fact we would say -
4 and that is without inviting you now to read through all of that again. I know you have
5 looked at it before. But, just glancing at it, we would say that there is very considerable
6 analysis of the relevant matters there - reference to Grid being a 'must deal' partner; the
7 seriousness of the threat made by British Gas; Grid's own view; the view of British Gas,
8 etc. Of course, it is paras. 3.86 to 3.88 in particular.

9 Just picking up 3.88, Mr. Turner quite rightly made the point - and we apologise for that -
10 that we have managed to mis-quote one of the bits of that document at 3.88 in our defence.
11 It is absolutely right that the penultimate sentence at 3.88 is correct, and in our defence we
12 had put it slightly incorrectly. But, the point remains good that this document which you
13 have at SD3, Tab 88, does suggest that Grid saw itself at that time in October 2003 as being
14 in a strong position. It may just be worth going back to the document for me to make that
15 good, so SD 3, tab 88.

16 MR. SUMMERS: May I just ask, in the second revised document that you circulated today,
17 which you said did contain certain corrections of errors, is it an error which is of the type
18 which has been corrected in this document?

19 MISS CARSS-FRISK: No, because the error happily is not in this document, the error is the error
20 in the defence.

21 MR. SUMMERS: Yes, that is fine.

22 MISS CARSS-FRISK: So it did not need to be corrected here. So tab 88, p.1435. So that, as you
23 have seen, is what is described as "Project Jam Way Forward". On p.1433 I think we
24 discovered, or it was mentioned yesterday it should be 2003 not 2002, the date. If you look
25 at 1435 under the heading "Current Status". "Project Jam at critical stage with two key
26 issues", and the second bullet point:

27 "We accepted an LOI (Letter of Intent) from BGT 10 months ago which doesn't
28 reflect the change in risk balance - we need to get past this"

29 I mention that only because it shows that what is said here is not confined to the non-British
30 Gas suppliers, but it actually deals more globally with the position. I picked that up
31 because, of course, the passage where the defence have misquoted refers to non-BGT
32 suppliers at para.3.88, so I just wanted to make it clear that the document as a whole is
33 concerned with the global position including British Gas, so under the heading "Context":

1 “Climate for effective competition not moved on at the pace originally envisaged
2 and stranding threat is therefore [materially] weaker than 12 months ago.”

3 Then the third bullet point:

4 “Competitive threat from non-BGT shippers in the short to medium term is low.
5 BGT finding mobilisation of MOs more difficult than expected.”

6 Then under the heading: “What we now want”:

7 “We still want to do a deal now because:
8 We are in a strong negotiating position now which may weaken as market
9 develops.”

10 I just wanted to emphasise that and clarify where we were.

11 THE CHAIRMAN: Is it then your case that the ultimate terms that were concluded were changed
12 from the letter of intent which was arrived at? The letter of intent was arrived at at a time
13 when people did not know that the CMOs were going to have so many teething problems,
14 what this is saying is: “Look, actually they have had all these teething problems, therefore
15 we should go back and try and do better”. Now, I think Mr. Turner took us to something
16 that showed that actually they did not or were not able to improve on the terms that had
17 been agreed before those teething problems became apparent and the shift in bargaining
18 power may have taken place. What do you say about that?

19 MISS CARSS-FRISK: We are just seeking to lay our hands on the letter of intent, but my
20 understanding is, and I will be corrected if I am wrong, that there was a reduction in rental
21 but that beyond that the essential terms of the deal remained as they had been.

22 THE CHAIRMAN: So it is not your case that they were able to take advantage ----

23 MISS CARSS-FRISK: That Grid were able to take advantage at that point

24 THE CHAIRMAN: -- that Grid were able to take advantage of the teething problems that had
25 become apparent in the roll out of the CMO contract?

26 MISS CARSS-FRISK: No, I do not think I can say that, it actually went the other way as I
27 understand it, but I will endeavour to find chapter and verse for you and do a precise
28 comparison.

29 The other point I just wanted to emphasise, it is para.3.84 of the Decision, and of course in
30 the documents, in the bundles, the reference to British Gas’s own assessment that an eight
31 year period they believe was the most aggressive exchange programme that could be
32 delivered.

33 Now, we have always accepted that some concessions, as I have suggested, were obtained
34 by British Gas, but what we would not accept is that they were substantial concessions and

1 there is overwhelming evidence to that effect. We will of course hear from Mr. Avery in
2 due course but, as we mention in our skeleton, he really just refers to a price comparison.
3 It is probably worth again coming back here to the point, just very briefly about what the
4 price reduction means, i.e. in exchange for the transfer of risk, as I have said – at least we
5 would suggest that played a big part in it. So far as British Gas’s bargaining stance is
6 concerned, as we have said in our defence (and I think repeated in our skeleton) it can really
7 be described pretty much as bluff and posturing. Grid, I think, has actually suggested that a
8 shorter period than eight years was a realistic threat in terms of accelerated replacement, but
9 as we have seen the reference in the defence that simply is not right, and there are several
10 documents that show that, that British Gas thought that eight years was the most aggressive
11 that could be achieved. It is important that Mr. Avery, as you will see, himself accepts that
12 there was an element of bluffing and posturing in all of this. Just for your reference it is
13 para.32 of his statement, he says in terms “Whilst we were telling National Grid that we
14 would exchange their meters in five to seven years we did not in practice intend to do that.
15 Again, in the passages I have taken you to in the Decision one sees a quote from National
16 Grid effectively saying: “We will take the risk and see how quickly you can do it, i.e.
17 saying: “We are prepared to call your bluff on this. So they knew that British Gas was
18 bluffing, and British Gas has effectively accepted it was, there we are it was a threat that
19 was made, if you like, but it does not seem that anyone believed it. On that basis we would
20 say it really does not indicate any overwhelming bargaining power on the part of British
21 Gas – far from it – certainly not enough to negate Grid’s power.
22 Now, Mr. Turner referred to EDF specifically in this context and he took you to some slides
23 at BP1 tab 6, I am not sure we need to look at them in detail again. I would just make two
24 points about that document: one, it does not appear to suggest any particular bargaining
25 strength on the part of EDF in its terms, and it is of course written in the context of someone
26 who is recommending that the legacy contract should be signed, p.56 of tab 6, so
27 understandably perhaps – no criticism – the author might indeed seek to present it in a way
28 that would suggest that it is not a matter of Grid exercising particular power. But,
29 ultimately, of course, we know that EDF decided not to sign up to the Legacy MSA, which
30 is significant, too, we would suggest. Similarly, perhaps without going to it, the other
31 document at SD3, Tab 108, which Mr. Turner referred to, again it should be seen in the
32 context that EDF chose not to sign the deal despite, in that document, appearing to be very
33 confident of their position in relation to that very deal.

1 MR. SUMMERS: Is it the case that they did not sign the contract or that they decided to delay
2 signing the contract?

3 MISS CARSS-FRISK: They decided not to go with the Legacy MSA at all.

4 MR. SUMMERS: Thank you.

5 MISS CARSS-FRISK: As far other suppliers, or suppliers more generally, I should pick up a
6 point we have made in the defence and in the skeleton which is that the documents suggest
7 that on what they saw as their top issues about the Legacy MSAs they were not able to
8 achieve anything at all in their negotiations with Grid. The relevant passages in the
9 Decision, for your note, are paras. 3.95 to 3.98. But, the documents which set out this
10 business of their issues and what happened are, first of all, at SD3, Tab 89, which I would
11 invite you to go to at p.1444. There you have an internal e-mail within Grid. One sees that
12 it says, on looking at the second half of the page,

13 "Colin, Richard asked me to send you a copy of the updated shipper matrix, which
14 reflects the latest discussions with shippers on Jam. I have also included the top
15 issues for each shipper, as you suggested".

16 If one then goes to p.1459 one sees there the top three issues set out for the various
17 suppliers. We have this in detail at paras. 150 to 152 of our defence, i.e. a detailed
18 commentary on all of this. However, can I just say that if you compare those top three
19 issues for the suppliers to the situation a little bit later chronologically, in January 2004, you
20 will see that nothing had changed.

21 The next document then is SD3, Tab 103, p.1543. You see there the left-hand column:

22 "Status/Issues: British Gas - None outstanding: LE Group - Very nervous about
23 eighteen year contract --"

24 As I say, the point is that they were not able to achieve any change on the key issues.

25 Finally under this heading we have referred also in our skeleton to one of the document
26 actually annexed to Grid's own skeleton here, which you have at SD2, Tab 57. It is another
27 perhaps small-ish piece of the puzzle, but, nevertheless -- It is an Npower briefing note,
28 dated 7th February, 2003, which again suggests that there was very little scope for
29 negotiation with Grid in relation to these contracts. It is p.1247, starting at the bottom of the
30 page,

31 "MDS have modelled (on behalf of Npower) the level of discount required to
32 match the British Gas reduction, and concluded that the charge for a credit meter
33 should be reduced by around £4 per meter per year. Transco have yet to make a
34 firm offer, but have strongly indicated that their proposed reduction will be in the

1 region of around £2. they have further indicated that there will be little room for
2 negotiation around this offer”.

3 That really completes, as I suggested, what we are going to say about the negotiations with
4 suppliers at this point.

5 Can I then just mention, Mr. Turner issued a heartfelt complaint yesterday about, well, the
6 argument about sunk costs and how that put Grid in a terribly weak bargaining position and
7 that that had been ignored by the Authority. Can I just say that it is specifically referred to
8 in para. 3.76 of the Decision. We would say that on any fair reading of the Decision - and
9 following analysis - it is apparent that the Authority has noted the argument, taken it on
10 board, but concluded that in the light of all the circumstances that they set out in some
11 detail, Grid nevertheless had market power.

12 I should mention perhaps Professor Grout’s analysis here. You may recall that his report
13 refers to how sunk costs can actually weaken ----

14 THE CHAIRMAN: If you are leaving the negotiations now -- One thing that is slightly curious is
15 that it seems that National Grid is negotiating separately with each of the gas suppliers, but I
16 thought we saw somewhere - or it was said - that because of non-discrimination obligations
17 it has to apply the same terms to everyone. Or, is that only in relation to price? To what
18 extent would it have been possible for them to meet these concerns for the individual person
19 expressing them? There, does then the best, most favoured nation apply - that they then
20 have to give that concession to everybody?

21 MISS CARSS-FRISK: Yes. As I understand the position, Grid said, certainly to the suppliers,
22 that they could not really change, as I understand it, any of the significant aspects of the
23 deal because of this non-discrimination obligation. Our position would be, “Well, that
24 really was something of an excuse being offered” because one could not read the non-
25 discrimination obligation as being an absolute obligation. Of course, as in relation to any
26 such obligations there is always a question of objective justification. Is there good reason
27 for treating someone differently? Sometimes the obligation not to discriminate means that
28 you must treat people who are in a different position differently. So, frankly, it does not
29 appear to us that that was much more than an excuse. I am sure that there will be protests
30 on that, but that is just describing ----

31 MR. TURNER: Madam, I will just clarify. As you see from these documents, the negotiations
32 were conducted with the other gas suppliers as well on the evolving proposal. To that
33 extent, non-discrimination does not come in yet. Once the deal had been signed and
34 crystallised with British Gas, then National Grid says, “We’re not able now to

1 discriminate”. In response to Mr. Summers’ question, the position with EDF is that they
2 were late, and that explains the dates on the documents you have seen. The complaint was,
3 “Well, now that we have come on the scene, we are being told we cannot be given different
4 terms”. That is where the non-discrimination obligation came into play.

5 MISS CARSS-FRISK: For your reference, it is para. 3.96 of the Decision at p.63 where reference
6 is made to this point and to how Grid had raised it. You have,

7 “The relevant licence conditions requiring the licensee (National Grid Gas plc) to
8 conduct its transportation business (which includes the provision of metering
9 services for the purposes of this condition) in the manner best calculated to secure
10 that no gas supplier obtains any unfair commercial advantage (including in
11 particular any such advantage from a preferential or discriminatory arrangement)
12 and to avoid undue discrimination and undue preference between any persons or
13 class or classes of persons in the provision of metering activities. This is not an
14 absolute obligation not to discriminate. Provided that any differences in terms
15 could be objectively justified, the licence condition does not prevent National Grid
16 offering different terms to different suppliers”.

17 So, that is how it is put in the Decision. I probably put it slightly more highly than that.

18 Mr. Kennelly and Mr. Jones have helpfully found the reference to the letter of intent - SD2,
19 Tab 51.

20 Professor Grout’s analysis then about how sunk costs can give the incumbent an advantage.
21 I think Grid is actually objecting to us putting that argument forward. However, we would
22 say, “Well, it’s simply a response to Grid having said in their Notice of Appeal that sunk
23 costs automatically weakened the bargaining power of Grid” (Notice of Appeal, para. 305).
24 Of course, Dr. Williams’ first report also makes that point. So, we say that here we have our
25 economic expert (or one of them) putting forward, as it were, a counter-argument. What is
26 wrong with that, we ask rhetorically.

27 In our skeleton - and perhaps no need to go to it now - we have cited the *All Sports* case
28 (Authorities Bundle 3, Tab 57, paras. 59 to 62), just setting out the basics. I am sure you
29 will be very familiar with it, as to when an Authority can adduce further evidence or further
30 materials, etc. We would say that this falls precisely within what is contemplated there in
31 terms of responding to an Appellant’s points.

32 So far as the substance of that debate is concerned, of course you have to hear it from
33 Professor Grout and Dr. Williams in due course. Really, Professor Grout says, “Well, it
34 does not matter for these purposes that the CMOs may be able to decide, or have their

1 contracts actually agreed before they sink their costs”. That does not undermine his analysis
2 that the incumbent’s sunk costs may give it an advantage because of its incentive to
3 compete aggressively etc. So, he will say, “Well, in fact, those sunk costs, far from
4 undermining Grid’s strength, may have created further barriers to entry for the CMOs, or
5 may have affected the terms on which the CMOs were prepared to enter”. But, as I say, you
6 will of course hear from Professor Grout about that.

7 Finally here, I should perhaps pick up the reference to Mr. Howdon, on the part of Ofgem,
8 having expressed a view that Mr. Turner would say was somehow inconsistent with our
9 case. Just to remind you, that is SD2, Tab 56. It is right that Mr. Howdon is a senior
10 economist at Ofgem, although he is not the senior economist. He is one of several. He is
11 not at director or managing director level. If one looks at what he says at para. 15 of this
12 document, which was dated 5th February, 2003 to the management committee. At para. 15,
13 which you were taken to, on p.1244 he says,

14 “Allowing Transco to sign commercial contracts with shippers would seem to be
15 the most effective means of ensuring an efficient industry outcome. [So far,
16 entirely neutral.] Transco’s licence requires them to provide meters upon shipper
17 request and these meters would be provided on the current price controlled terms
18 with no premature replacement charge unless a shipper requested otherwise. This
19 weakens the ability of Transco to abuse market power in setting the terms of its
20 metering contracts since the regulated default option is always available”.

21 I have made our submissions about the availability of the default option. The point I would
22 make here is that, of course, Mr. Howdon is actually talking about the ability to abuse
23 market power being somehow weakened. But, he is actually not dealing with the prior
24 question of whether Grid was dominant at the relevant time, which we say, on all the
25 evidence, it clearly was.

26 Moving on then to the question of abuse ----

27 THE CHAIRMAN: How much longer do you intend to go on this afternoon? I am considering
28 whether we should take a break.

29 MISS CARSS-FRISK: I am entirely in your hands. I think I am making quite good progress. So,
30 there probably is no need to sit any later than you otherwise would. As I say, I am entirely
31 in your hands.

32 THE CHAIRMAN: Let us continue then until you come to a convenient point at some point after
33 four o’clock.

1 MISS CARSS-FRISK: I will press ahead with what we say about the law on abuse. That may be
2 convenient. That is something we deal with at pages 25 to 68 of our skeleton. That seems a
3 very long chunk, but I am not going to go through all of it. Of course, there is no real
4 dispute, I do not think, about the relevant legal principles. It is probably more about their
5 application in this case. But, referring to the Commission's discussion paper of December
6 2005, which you have at A5, Tab 74, I would just like to emphasise the point made at para.
7 58 of that paper about how it is not necessary -- This is referring to the definition of
8 exclusionary abuse as set out in *Hoffmann-La Roche*. Then at para. 58,

9 "This definition implies that the conduct in question must in the first place have
10 the capability, by its nature, to foreclose competitors from the market To establish
11 such capability it is in general sufficient to investigate the form and nature of the
12 conduct in question. It secondly implies that, in the specific market context, a
13 likely market distorting foreclosure effect must be established. By foreclosure is
14 meant that actual or potential competitors are completely or partially denied
15 profitable access to a market. Foreclosure may discourage entry or expansion of
16 rivals or encourage their exit. Foreclosure thus can be found even if the
17 foreclosed rivals are not forced to exit the market --"

18 I emphasise that really in response to one of the points Grid has made, which is, "But, look,
19 the CMOs are in business. They have not been completely excluded from the market".
20 Well, that is not an answer. But, the key issue, perhaps, is what is meant by normal
21 competition. In relation to that we would ask you to look at para. 54 of the same discussion
22 paper still (Tab 74 in A5, p.3209): "The essential objective of Article 82 when analysing
23 exclusionary conduct is the protection of competition on the market as a means of
24 enhancing consumer welfare and of ensuring an efficient allocation of resources. The
25 concern is to prevent exclusionary conduct of the dominant firm which is likely to limit the
26 remaining competitive constraints on the dominant company, including entry of newcomers
27 so as to avoid the consumers are harmed. This means that it is competition and not
28 competitors as such that is to be protected. Furthermore, the purpose of Article 82 is not to
29 protect competitors from dominant firms' genuine competition based on factors such as
30 higher quality, novel products, opportune innovation or otherwise better performance, but to
31 ensure that these competitors are also able to expand in or enter the market and compete
32 therein on the merits without facing competition conditions which are distorted or impaired
33 by the dominant firm."

1 Of course, we stress here that we are not, in our submission, concerned with competition on
2 the merits in the sense that it is just described there in that we are not concerned with Grid
3 offering a particularly good service, etc. or competing on price. We are concerned here
4 with Grid saying that normal competition, or I suppose they would say competition on the
5 merits includes our entitlement to protect our sunk costs in this way and to guarantee our
6 revenue stream.

7 THE CHAIRMAN: I am not sure that is quite how they put it. I think how they put it is that the
8 competition that takes place is as to which is the best contract where all those contracts
9 make some provision for the supplier to protect their sunk costs from being stranded that
10 the competition is between contracts which all share that feature.

11 MISS CARSS-FRISK: Well insofar as, if I understood, madam, your point, insofar as we are
12 talking about whether there was in some sense a competition at the time when the MSAs
13 were entered into we would say that first of all one needs to bear in mind then the
14 dominance and the advantage of course of Grid at that stage, but also that would not, in our
15 submission, meet the point as to the exclusionary effect of the contracts then entered into
16 and their effect on competition more broadly in the market as in the ability of the CMOs to
17 enter and expand, etc.

18 Of course, as I said at the outset, we do stress that special responsibility of the dominant
19 undertaking which concept Grid has not, to my knowledge, ever disputed as a relevant legal
20 principle, and I am not sure how it could but, as I said before, it has never faced up to in the
21 course of these proceedings. Perhaps I could just take you to one authority *Van den Bergh*
22 *Foods at Authorities' bundle 3, tab 49, paras. 157 to 159 at 157 there is a reference to*
23 *Hoffmann-La Roche* and then at 158:

24 “Consequently, although a finding that an undertaking has a dominant position is
25 not in itself a recrimination, it means that, irrespective of the reasons for which it
26 has such a dominant position, the undertaking concerned has a special
27 responsibility not to allow its conduct to impair genuine undistorted competition on
28 the common market.

29 159. The Court finds, as a preliminary point, that HB rightly submits that the
30 provision of freezer cabinets on a condition of exclusivity constitutes a standard
31 practice on the relevant market. In the normal situation of a competitive market
32 those agreements are concluded in the interests of the two parties and cannot be
33 prohibited as a matter of principle. However, those considerations which are
34 applicable in the normal situation of a competitive market, cannot be accepted

1 without reservation in the case of a market on which, precisely because of the
2 dominant position held by one of the traders, competition is already restricted.
3 Business conduct which contributes to an improvement in production or
4 distribution of goods and which has a beneficial effect of competition in a
5 balanced market may restrict such competition where it is engaged in by an
6 undertaking which has a dominant position on the relevant market. With regard to
7 the nature of the exclusivity clause, the Court finds that the Commission rightly
8 held in the contested decision that HB was abusing its dominant position on the
9 relevant market by inducing retailers who, for the purpose of stocking impulse ice-
10 cream, did not have their own freezer cabinet, or a cabinet made available by an
11 ice-cream supplier other than HB, to accept agreements for the provision of
12 cabinets subject to a condition of exclusivity. That infringement of Article 86
13 takes the form, in this case, of an offer to supply freezer cabinets to the retailers
14 and to maintain the cabinets free of any direct charge to the retailers.”

15 Perhaps a little bit too much factual detail there that we do not really need, the key point is
16 obvious. What might be perfectly acceptable in a competitive market will not necessarily
17 be so where you already have an effect of the dominant undertaking.

18 The third matter I wanted to mention so far as the law is concerned, is that of course all the
19 Authority has to show, and this really already comes from the Commission’s discussion
20 paper and it is probably common ground, is that the MSAs had a likely foreclosing effect on
21 competition or, to put it slightly differently, that they were capable of having that effect, or
22 tended to have that effect, so it is not actually necessary to show actual effect even though
23 we have done so, we say in this case and made such a finding, and that is the *British*
24 *Airways* case at A3, tab 51 – perhaps no need to go to that.

25 So far as harm to consumers is concerned, of course the Authority did find that the effect of
26 the MSAs has been to cause such harm but I would just make the point that legally it is not
27 necessary of course to show direct impact on consumers in that way, that is another point
28 coming out of the *British Airways* case and perhaps it should be turned up just for that point
29 (vol.A5, tab 76). (After a pause) I am sorry, I fear I may have the wrong reference here,
30 forgive me. Everyone is very kindly trying to help me, I am very grateful – it is A5, tab 76.

31 THE CHAIRMAN: This is the Court of First Instance.

32 MISS CARSS-FRISK: I now see I had made a note of the correct reference, A5, 84.

33 THE CHAIRMAN: The reference that you gave us before ----

34 MISS CARSS-FRISK: That was A3, tab 51. So this is tab 84 in tab A5, para. 106 at p.3798:

1 “Moreover, as the Court has already held in paragraph 26 of its judgment in *Europemballage*
2 *and Continental Can*, Article 82EC is aimed not only at practices which may cause
3 prejudice to consumers directly, but also at those which are detrimental to them through
4 their impact on an effective competition structure, such as is mentioned in Article
5 3(1)(g)EC.”

6 We have referred in our skeleton also, which I just draw to your attention for your note, to
7 the opinion of Advocate General Kokott in that case, which is in the same bundle at tab 76,
8 which is important in our submission because of its emphasis on the whole scheme of
9 Article 82 being to protect the structure of the market and thus competition as an institution
10 with consumers being indirectly protected, and that is para. 68 of his Opinion.

11 It is actually 4 o’clock, and that is the end of what I was going to say about the law, so that
12 may be a convenient moment?

13 THE CHAIRMAN: Well provided that you are confident that you will be able to finish by – is it
14 lunchtime on Monday?

15 MISS CARSS-FRISK: Yes, I shall make sure I do.

16 THE CHAIRMAN: Do we need to start early or shall we start at 10.30?

17 MISS CARSS-FRISK: I would have thought 10.30 would be enough. It may be, as I said, that
18 will produce something in writing in response to Grid’s notes.

19 THE CHAIRMAN: Thank you very much. We will resume at 10.30 on Monday.

20 (Adjourned until 10.30 a.m. on Monday, 19th January 2009)