

This Transcript has not been proof read or corrected. It is a working tool for the Tribunal for use in preparing its judgment. It will be placed on the Tribunal Website for readers to see how matters were conducted at the public hearing of these proceedings and is not to be relied on or cited in the context of any other proceedings. The Tribunal's judgment in this matter will be the final and definitive record.

IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1099/1/2/08

Victoria House,
Bloomsbury Place,
London WC1A 2EB

22nd 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

*Transcribed by Beverley F. Nunnery & Co.
Official Shorthand Writers and Tape Transcribers
Quality House, Quality Court, Chancery Lane, London WC2A 1HP
Tel: 020 7831 5627 Fax: 020 7831 7737*

HEARING (DAY 6)

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: Mr. Randolph?

2 MR. RANDOLPH: I have a note to hand up to the Tribunal, if I may. We promised this a couple
3 of days ago, with regard to our charging provisions in our contract., you will recall, madam.
4 I have six copies for the Tribunal. I trust that will be of assistance.

5 THE CHAIRMAN: Thank you very much. Miss Carss-Frisk, did you want to say something?

6 MISS CARSS-FRISK: Not about the note, no. There is a concern at our end about a fresh bundle
7 that has just been produced by National Grid, which consists of documents that are to be put
8 to Mrs. Frerk in cross-examination. One problem with this bundle is that there are at least
9 two tabs of documents that have not been included in any bundle previously, including the
10 miscellaneous bundle that we debated earlier, and therefore come, I am afraid, by way of
11 complete ambush for us, and we do submit that it is not fair that Mrs. Frerk should be asked
12 about those documents at any rate when no one in her team, and she herself above all, has
13 had no chance to consider these documents in advance at all.

14 THE CHAIRMAN: Is that right, Mr. Turner? I thought that these documents were just to make it
15 quicker to find things, rather than have to pull different bundles from the shelves
16 continuously. Are there documents in here which are not included in any of the existing
17 bundles?

18 MR. TURNER: Almost all of the documents do fall into that category, and that is the intention,
19 to make things quicker.

20 THE CHAIRMAN: Into which category?

21 MR. TURNER: The category of documents which from this array of bundles which have been
22 collected here to save time when Mrs. Frerk is cross-examined. There are two documents
23 which do not fall into that category, but neither of which will it be unfair for Mrs. Frerk to
24 be cross-examined on. I would suggest that we take that in stages. One of them is a
25 document from the case file, with which Mrs. Frerk will be acquainted, but which did not
26 find its way inadvertently into the case bundles.

27 That is an irrelevance from this point of view. The other is a presentation of the price
28 reductions that National Grid effected under the MSAs, simply so that those price
29 reductions can be shown to Mrs. Frerk. Obviously there was no document existing in the
30 bundles which did precisely that. It will not, however, be a problem for cross-examination.

31 THE CHAIRMAN: I do not see, Miss Carss-Frisk, that there is a difficulty in putting documents
32 to Mrs. Frerk. Obviously she has not seen them before. There may be a limit to how
33 helpful she can be, and I will certainly bear that in mind if I think that Mr. Turner's
34 questioning is moving in an unfair direction, given the circumstance that she has not had the

1 opportunity to look at these documents. I do not think I can rule out putting to her any
2 document simply because she has not seen it yet in cross-examination. Let us proceed with
3 the cross-examination and see where we get to. I note the point that you make and that
4 Mr. Turner has confirmed. Thank you.

5 MISS CARSS-FRISK: I then call Mrs. Frerk to give her evidence.

6 Mrs. MAXINE FRERK, Affirmed

7 Examined by Miss CARSS-FRISK

8 Q Mrs. Frerk, if you were able to have in front of you WS2 as the relevant bundle, I hope you
9 will find that the first document there is a witness statement that you signed for these
10 proceedings on 11th June last year. A. It is.

11 Q Are you content for that to be your evidence in this case? A. I am.

12 MISS CARSS-FRISK: Thank you, if you would wait there for some questions.

13 Cross-examined by Mr. TURNER

14 Q Mrs. Frerk, do you have as well as WS2, bundle CB1, which contains Ofgem's Decision,
15 and the bundle marked Frerk 1? A. Yes.

16 Q You are currently Director Governance, Social and Consumer Affairs at Ofgem? A. I
17 am.

18 Q You first joined Ofgem in February 2002 as Director of Metering and Co-ordination?
19 A. I did.

20 Q You held that post until March 2004 when your responsibility for metering passed to your
21 colleague Iain Osborne? A. That's correct.

22 Q In your post as Director Metering Co-ordination you were closely involved in dealing with
23 National Grid in relation to metering matters? A. I was.

24 Q And specifically issues concerning the opening up of metering to competition? A. Yes.

25 Q You were also responsible subsequently for overseeing the drafting of the licence conditions
26 implementing price control on National Grid? A. Yes, I was overseeing it, yes.

27 Q And you understand the way control works? A. At a high level, yes.

28 Q Before joining Ofgem you worked with British Telecom and you were the head of UK
29 regulation? A. I was.

30 Q What did your responsibilities there involve? A. I was responsible for all the interfaces
31 with Oftel for anything to do with BT's retail business and for ensuring that any of the
32 proposals that the business was developing on pricing complied with regulation and with
33 competition law, taking advice from the lawyers, as necessary.

1 Q Would you please open up bundle CB1, and at tab 1 look at the Decision at p.1. Do you
2 have that? A. Yes.

3 Q At the foot of the page under “Team” we see your name, so you are listed as one of the team
4 responsible for making this Decision? A. Yes.

5 Q And you had read the Decision? A. Yes.

6 Q Do you agree with its contents and its reasoning in all respects? A. Yes, though
7 obviously there may be individual words that wouldn’t be the words that I would have
8 chosen, but I was part of a team and supported the Decision, yes.

9 Q You agree with its reasoning in all respects? A. Yes.

10 Q Did you contribute to or read Ofgem’s defence? A. Yes, I saw drafts of it, and would
11 have provided some comments.

12 Q Again, you agree with its reasoning in all respects? A. Yes.

13 Q You also played a role in the administrative investigation which led to the Decision – is that
14 right? A. Yes.

15 Q You attended, I think, the first oral representations meeting with National Grid after the first
16 statement of objections? A. I did.

17 Q That was in September 2006? A. I think so, yes.

18 Q Do you remember that you asked some questions at that stage? A. I don’t recall, but it’s
19 very possible.

20 Q In your statement, if we could open that up, WS2, paras.11 and 12, you are referring there to
21 the basis of the 2002 price control which you were subsequently involved in implementing
22 – yes? A. Yes.

23 Q You refer at para.12 to Mr. Smith’s witness statement at paras.34 to 50 about the price
24 control? A. Yes.

25 Q You have read it? A. Yes.

26 Q You say there that you agree with his description of the way the control worked? A. Yes.

27 Q Do you still agree? A. Yes.

28 Q The transcript of the oral representations meeting, which you attended and which you spoke
29 at, is at tab 1 of the cross-examination bundle, if you could turn to that. Could you turn in
30 that transcript, which is an agreed transcript, to p.2325 of the bundle numbering, which is
31 p.108 of the internal numbering? A. Yes.

32 Q At the top of the page, we have your colleague, Mr. Smith, saying:
33 “I think the price cap was set at a level that reflected some degree of stranding and
34 therefore was deliberately raised to allow some accelerated recovery was our

1 understanding, and therefore in some sense if you had the meters on the wall for a
2 year or two and were charging those rates, then you would be over-recovering ...
3 that was my understanding.”

4 You added: “You reduce it to 15 years from 20”. Do you see that? A. Yes.

5 Q So you were referring there to there having been a reduction in the depreciation period for
6 National Grid’s installed meters to 15 years from 20? A. Yes.

7 Q That view of yours, we know, then passed into the Decision and we see it at 2.49 – I am not
8 going to ask you go to there now, but you recall that being reflected in the Decision? A. I
9 think what would have been reflected in the Decision is something that would have been
10 checked; these are my comments in an oral hearing. I was not involved in the basis on
11 which the price control was set, which was about reducing it from the depreciation period. I
12 was only concerned in how it worked afterwards, i.e. what the levels of prices were, what
13 the reopening clauses were, not the basis on which it was set, so my question there was
14 based on understanding how it got from comments Mr. Smith had made previously, and I
15 am sure the Decision would have reflected us having checked back on documentation rather
16 than simply relying on any comment I made at the oral representation.

17 Q That is quite fair. Shall we then look at paragraph ----

18 THE CHAIRMAN: That Mr. Smith, is that Mr. Stephen Smith?

19 MR. TURNER: Yes, it is.

20 THE CHAIRMAN: Is that the same Mr. Smith as the witness in this case?

21 MR. TURNER: Yes, it is Mr. Stephen Smith. Would you turn to para.2.49 in the decision and
22 then you will see what is said there. You will find it on p.22 of tab 1 in the CB1 bundle.
23 Read that to yourself for a moment? A. (After a pause) Yes.

24 Q Do you still hold the view that the depreciation adjustment reflected a significant degree of
25 stranding? A. Sorry, could you repeat the question.

26 Q Do you still hold the view which you articulated at the oral representations’ meeting and
27 which is reflected in para.2.49 of the Decision as being the second adjustment made by
28 Ofgem, the assumption of shorter metering assets lives, that this reflected a significant
29 degree of stranding? A. I do not think we say anywhere that it reflected a significant
30 degree of stranding, it was an adjustment that was made, that would allow National Grid to
31 avoid some element of stranding.

32 Q Yes, I am quoting Mr. Smith’s words as they were at the oral representation meeting. We
33 see from this the Decision also referred to another adjustment, that is the first in this
34 paragraph, the fact that the cost of capital for the metering business was set 0.75 points

1 higher than the cost of capital in the gas transportation business “to reflect the influence of
2 competitive pressures”, those are the words in the Decision – do you see that? A. Yes.

3 Q Do you still hold the view that this second adjustment reflects at least some degree of asset
4 stranding? A. Again, it was intended to allow National Grid a higher rate of recovery
5 given that it was facing more risk on those assets as the market opened to competition.

6 Q Do you recall that National Grid sent to you a letter following the oral representations’
7 meeting at which you spoke and addressed both these issues which are now in the Decision
8 as findings. Do you recall that letter? A. I don’t recall that letter, no.

9 Q If you turn to tab 2 in the cross-examination bundle you will see this letter. It is dated 20th
10 October 2006. This letter was not referred to by Ofgem in the Decision and nor, I think,
11 were the written representations dealing with issues in para. 2.49 at all. Did you consider
12 this letter and read the Ofgem documents to which it referred to remember whether you did?

13 A. I do not remember whether I did. This was not something that I was viewed as being a
14 particular expert on. I, as I said before, was not involved in the original discussions about
15 price control. Mr. Steve Smith would have been the person who would have looked at this
16 letter and assessed whether or not it was – or some other member of the case team; but this
17 would not be something on which I would be expected to comment, since I had not been
18 involved in those discussions at the time.

19 Q Nevertheless, in your written evidence to the Tribunal you said that you understand the way
20 that the price control worked having agreed with Mr. Stephen Smith’s description of it in
21 paras. 34 to 50 of his statement? A. Yes. The way the price control works is about how
22 it is put into the licence, i.e. in terms of what amount of money they are now allowed to
23 recover, and any conditions around it for reopening the price control. I was not saying that I
24 understood the basis on which all of those numbers were arrived at, which is a very
25 different issue. I had a broad understanding. In particular the big debate which came out
26 through my discussions with Grid about focused and unfocused, and the fact that we were
27 aware that they thought they faced a stranding risk, and that that had been taken into
28 account in the overall settlement of the price control. But certainly my intention was not to
29 suggest that I understood the basis on which the price control levels were derived, only that
30 I understood how they were applied through licence which, for example, makes no
31 reference to cost of capital.

32 Q Well, Mrs. Frerk, first, I think that was the comment that you made at the oral
33 representations’ meeting to National Grid? A. Yes, that was in the form of asking a

1 question based on the discussions that I had heard around the table and was supporting Mr.
2 Smith in one of his questions.

3 Q I will bear in mind the extent to which you are able to assist the Tribunal on this, but you
4 also explicitly agree with Mr Smith's evidence at paras. 34 to 50 of his statement. Could
5 Mrs. Frerk be given WS3, please, which contains Mr. Smith's evidence with which she
6 agrees? Please turn in bundle WS3, within the first tab, marked tab 7, to p.1441, within the
7 section that you agree with, and look at para.43.

8 "The particular risk which NG highlights is the risk of asset stranding. However,
9 this was explicitly taken into account by Ofgem in the 2002 Price Control..."

10 Then we have the two factors. Were you perhaps a little hasty in agreeing with that in your
11 evidence? A. That has always been my understanding from my colleagues who are the
12 experts on this matter in Ofgem. I do not feel particularly qualified to comment on the
13 accuracy of this versus any other representations.

14 Q Well let us make what progress we can, and enter those caveats as you feel appropriate.
15 Please could we return to the letter of 20th October 2006, and put away WS3. Would you
16 look at the second page of the letter and look at the statement in the paragraph at the bottom
17 of the page, beginning: Fifthly' where National Grid refer to the depreciation lives issue.
18 Just read that to yourself. (Pause whilst read): The point made by National Grid was that
19 there was no reduction in the assumed asset lives of installed assets. There was an
20 assumption of a twenty year asset life. It remained as it had been before. Are you prepared
21 to accept that? A. I don't feel that I'm particularly qualified to comment on that. It may
22 well be true. But, even if it is, there are assets that were installed after 2002, going
23 forwards, on which the shorter life would be allowed in recognition of the fact that they
24 would have ----

25 Q We will come to that in just a moment. I understand your qualification. Let us look at the
26 other factor - the increase in the metering price cap to make it 0.75 percent higher than the
27 monopoly transportation business price cap -- the gas transportation business. Now, this
28 adjustment, we are told by the Decision, was 'made to reflect the influence of competitive
29 pressures outside a monopoly business'. That is what the Decision says. You agreed with
30 Mr. Smith, who said that it explicitly took into account the risk of asset stranding. That
31 seems to put it a little high, does it not? A. I think it's recognised that in a competitive
32 business you face other risks which may be that you are not always going to be guaranteed
33 to get your money back on an investment in the way that you are in a regulated

1 Q Absolutely. For example, the increased cost of borrowing in a competitive environment.

2 A. I have to say, I don't know how National Grid does its borrowing. I would've assumed
3 that it borrowed at a group level rather than for the metering business, but I don't know.

4 Q Did you, or do you, know whether Ofgem ever worked out what sort of extra money these
5 adjustments added up to in the very short period between them being introduced by the
6 2002 price control and the time when National Grid began to charge much lower prices than
7 the price cap under the MSAs?

8 Q I don't know whether we ever did that calculation. For us, I mean, that was one factor that
9 we had allowed for in the price control to give them a little bit of extra headroom, but, for
10 us, the main point was that this issue had been considered in the round as part of a much
11 bigger price control with metering accounting for only a very small element, and that the
12 way that we had a set value to the metering assets we knew left Grid with a very significant
13 stranding risk. But, that basis for valuing the assets was one that gave them huge advantages
14 for the rest of their business, and therefore as a package the price control was of benefit to
15 them.

16 THE CHAIRMAN: This is the focused and unfocused question. A. The focused/unfocused
17 debate. For us, that was the much bigger bit - that we knew that they faced a stranding risk
18 and would almost certainly be losing money. We could have adjusted it through the price
19 control and moved the money on to the monopoly business, which is a way, in a regulated
20 sector, that you would typically deal with an issue of stranding, and it's what we did on the
21 electricity sector. We had chosen not to do that for National Grid because, as part of the
22 settlement, they were gaining a lot on another part of their business and they didn't choose
23 to take that decision to the Competition Commission, which they could have done. The
24 stranding issue was fully debated at that time. There were these other adjustments that we
25 were talking about now to the cost of capital and so on, but they were not a major part, and,
26 as far as I'm aware, we've not made a separate assessment of how much they contributed to
27 easing the asset stranding risk.

28 Q Do you accept now that as far as the depreciation point - from twenty to fifteen years - was
29 concerned -- I understand the point that is being made is that that only related to new assets
30 - not to the Legacy stock. But, are you able to confirm whether or not that is the case? A.
31 I'm not the expert, but I have no reason to disagree with that.

32 MR. TURNER: Madam, you will see the Decision itself at 2.49 refers to 'average' asset lives.
33 So, assuming that the assumed life is twenty years, the average would be ten, which is the
34 figure referred to in the Decision. That is National Grid's point.

1 (To the witness): Before we turn to what you have described a moment ago as ‘the bigger
2 issue’, I do not want to jettison completely the discussion of what Ofgem has also said in
3 para. 2.49 of the Decision. Therefore I wanted to ask you also about the other aspect - the
4 increased cost of capital. I was asking you a moment ago about whether Ofgem had ever
5 calculated what sort of benefit these adjustments would have given to National Grid. I
6 understand that you personally are not aware of whether that was done, or not. But, are you
7 aware whether Ofgem - or, indeed, whether you, if you can recall - read National Grid’s
8 written representations dealing with these matters in Summer 2007? A. I would’ve read
9 National Grid’s main representations. I would not necessarily have read all correspondence
10 that came from National Grid.

11 Q Can we turn, then, to the document that you would have read, which is at Tab 3? Those are
12 the written representations. Let us go within that to p.1214 of the bundle numbering, which
13 is p.38 of the internal numbering. A. (After a pause): I don’t have any external
14 numbering on this.

15 Q If you have got the internal numbering it is p.38. (After a pause): At the foot of that page,
16 under (d), just before (i) and (ii), we have the sentence,

17 “Turning to the effects of the Authority’s adjustments, in fact, the financial
18 consequences for National Grid were very small indeed:

19 (i) National Grid estimates that allowing a 7 percent rate of return instead of 6.25
20 percent was worth only around 50 pence per meter per year, amounting to a total
21 net benefit at most around £11 million over the thirteen and a half months prior to
22 the application of the lower MSA rental charges”.

23 Then, if you turn to (ii) where we look at what you referred to a moment ago - the effect of
24 the reduced asset life for the post-April 2002 assets (fifteen years instead of twenty) - that
25 amounts to a total net benefit of, at most, around £4 million over the thirteen and a half
26 months prior to the application of the MSA charges.

27 Now if you turn to (d), also on p.38, and look at the introductory sentence, -- We can
28 compare those figures with the expected loss of value due to the meter asset stranding even
29 with the MSAs -- £200 million or £400 million, depending on the tax treatment.

30 Do you accept that the adjustments (staying with these for the moment) are insignificant
31 compared to the risks of stranded costs of outstanding past investment by National Grid of
32 at least £200 million - if those figure are right? I obviously do not ask you to validate
33 them here in the box. A. (After a pause): Firstly, I am not sure that I would ever
34 describe £15 million as ‘insignificant’. We have not said that it fully accounted for their

1 stranding loss. The estimate of £200 million is an estimate that they were making based on
2 what they expected the rate of competitive loss of meters to be. So, I don't know whether
3 £200 million actually is what they now would estimate their loss as. So, it is a small part of
4 the total stranding that was being debated, but I don't think we ever pretended that it was
5 more than a contribution to that effect.

6 Q You will remember, in fact, from your discussions with the National Grid officials, I think,
7 that when they were speaking to you during the negotiations prior to the MSAs, the figure
8 being bandied about was more in the region of £400 or £500 million, but it came down to
9 this level. A. Yes, I think that was a figure that was discussed in the context of the main
10 price control discussions as well.

11 Q The more important point though, Mrs. Frerk, is one of principle so far as we are concerned,
12 because the MSAs are not contracts with cancellation charges which guarantee payment
13 completion of the P&M rental charges, and so avoid risks of competition, are they?

14 A. Sorry, could you repeat the question?

15 Q The MSAs do not contain exit charges in order to guarantee rental income at the level of the
16 P&M charges, and thereby insulate the company from competition, the risks competition,
17 do they? A. My understanding is that they guarantee a revenue stream that is slightly
18 lower than the P&M charges. Therefore, in some sense they are still protecting National
19 Grid against competition, but not perhaps the full effects of competition.

20 Q We will come back in a moment to what sense that is. National Grid competed with the
21 benefits that gas suppliers could gain by accelerating their replacement on the P&M terms,
22 and from 2004 National Grid operated on charges that were significantly below the price
23 cap, you would accept? A. Yes, and I think that was what we anticipated would happen.

24 Q The price cap and what could be recovered through P&M charging levels became an
25 irrelevance when National Grid began charging at the lower levels? A. I don't think it's
26 an irrelevance, it's still what National Grid are recovering with their contracts with EDF,
27 who remain on the P&M.

28 Q But not with their contracts under the Legacy MSAs? A. That's correct.

29 Q We are concerned, therefore, with payment completion arrangements, these cancellation
30 charges, for lower rentals, and those were the outcome of bargaining in a competitive
31 framework – would you agree with that? A. I think that is what we had assumed would
32 be the case, but in fact, and part of our decision was that – bargaining power sat with
33 National Grid and therefore it was not actually in a completely competitive market in the
34 sense that one would normally understand it.

1 Q I want to leave aside the question of dominance or market power, but as to the framework
2 National Grid was competing for the continued business of the gas suppliers with its term
3 contracts against the alternatives which those gas suppliers had available, which would
4 include the gas suppliers putting in new meters with their CMOs, also subject to term
5 contracts? A. Yes, so Grid was competing with the others, but had the advantage in the
6 fact that the meters in its case were already on the wall, so there was no customer disruption
7 involved, which obviously would give them some advantage in those negotiations.

8 Q That is what you describe as their advantage? A. I think that's one element of your
9 advantage, yes.

10 Q In your statement at para.10 you say that you at Ofgem were:

11 "... firmly of the view that the issue of stranding was an issue which both sides had
12 been well aware of in settling the terms of the latest price control ..."

13 This is the moment when we move to the wider issue of the focusing on focusing?

14 A. Yes.

15 Q But that is your evidence? A. Yes.

16 Q Ofgem, I think you may recall, was asked to produce any documentary evidence about that.
17 Do you remember that? A. I have some recollection, yes.

18 Q And do you recall also that there was none? A. I don't know whether we produced any
19 or not.

20 Q There was none. Can we turn to para.11 of your statement. Could you read that to yourself.
21 That relates to the issue of the focus or unfocused approach to the evaluation of the assets.
22 Your evidence before the Tribunal is that this was financially very beneficial to NG – to
23 National Grid? A. Yes.

24 Q Did you read Mr. Shuttleworth's report on this issue? A. I haven't read Mr.
25 Shuttleworth's report on this issue. I know I personally sat in on a conference at one stage
26 where Chris Bolt, their director of regulation made that point, and I believe that we did
27 actually provide things like press releases that were put out by National Grid after the price
28 control closed that highlighted the fact that the focused approach that we had taken was
29 something that had been one of their major successes and wins. That is my understanding.

30 THE CHAIRMAN: The "unfocused approach"? A. Sorry, the unfocused approach.

31 MR. TURNER: Shall we turn to Mr. Shuttleworth's report. It should be at tab 4 in your cross-
32 examination bundle. Would you go in that report to p.3417, internal numbering p.25. Can
33 you read for yourself para.83, the last paragraph on that page. You agree that the unfocused
34 approach had been consistently adopted by the MMC and by Ofgas/Ofgem as the

1 appropriate way to value the assets since 1997. You agree with that? A. That's my
2 understanding. This is not an area on which I am a particular expert, but I will share with
3 the Tribunal my understanding as best I can.

4 Q Again it is an area on which you have given evidence to the Tribunal, now orally as well as
5 in your written statement. You would also agree that relative to the previous valuation of
6 the regulatory value at end 1991 the overall value of the assets was discounted, the market
7 to asset ratio, and not raised? A. I'm afraid I'm not in a position to answer that question.

8 THE CHAIRMAN: That is the taking it at 60 per cent of its value because of the value of the
9 company on flotation.

10 MR. TURNER: That is right, that is what happened in 1991, albeit several years after the actual
11 date of privatisation, which I believe was 1986. Then in 1997 we have the application of
12 this unfocused approach to the asset base of the MMC? A. Yes.

13 Q And we have that consistently adopted since then. You see here from para.83 that at
14 various times, both Ofgem and the MMC have described the focused approach as illogical
15 and not justified, and in short they considered that the unfocused approach was the
16 appropriate way to value the assets. Do you see that? A. Yes.

17 Q So there is no basis for using the hypothetical of a focused approach as a benchmark to
18 suggest that National Grid has received a windfall, is there? A. As I say, I was not
19 around at the time that price control happened. I do know that the director of regulation at
20 the time certainly viewed that as a success for them. I think any company in negotiated
21 price control is never sure exactly where they are going to land; and also the question of –
22 I'm not saying we thought it was a windfall for them, but they felt they had done well out of
23 the overall price control package. (After a pause) Go on.

24 Q I am sorry, you put on the light so I thought you were going to address a question. Miss
25 Frerk, or Mrs. Frerk, is it your evidence before the Tribunal that National Grid somehow
26 had no entitlement to seek commercially to protect itself against the asset stranding risk as a
27 result of any of this. Is that your position? A. It is my position that we had debated
28 those issues and therefore its level of entitlement was not the same as it might otherwise
29 have been, so I do not think it has absolute entitlement to those revenues. There are, in my
30 view, and my position in front of the Tribunal is that there are other ways in which that
31 issue should have been tackled, and could have been tackled. It was debated in the price
32 control and was not settled.

33 Q I am not talking about entitlement to any particular level of revenues. What I am putting to
34 you is, are you saying that National Grid was not entitled for some reason to seek to protect

1 itself by way of cancellation charges against the risk of asset stranding? A. Not if that
2 had an anti-competitive effect.

3 Q That is your qualification. Now then, let us turn to your discussions between National Grid
4 and Ofgem, and this is what most of your evidence concerns, your discussions with
5 National Grid between 2002 and 2003? A. Yes.

6 Q Between February 2002 and February 2003 you met regularly with National Grid's
7 officials? A. I did.

8 Q About once a month? A. Yes.

9 Q And among the topics that you discussed with National Grid were stranding and premature
10 replacement of meters? A. Yes.

11 Q Can we take a step back and remind ourselves asset stranding refers to a situation where a
12 working meter is replaced before the operator is able to recover the costs of meter provision
13 and installation – do you agree with that? A. That sounds a fair definition.

14 Q You will find it in your metering strategy update. Such replacement of functioning meters
15 is referred to as premature replacement? A. Yes. I think there is a difference in that
16 maybe premature replacement means before the end of its working life, and stranding has a
17 financial context to it ----

18 Q The stranding of the costs? A. The stranding of the costs i.e. before the costs have been
19 recovered.

20 Q Yes. Now, at the time when you took up your post at Ofgem, stranding and premature
21 replacement of meters were issues about which industry participants were concerned?
22 A. Yes.

23 Q And that was because, according to them, it would cause unnecessary customer disruption
24 and economic inefficiency? A. Yes, I think different parties had different interests in the
25 issues, those were two of the broad areas.

26 Q We know that it was a major concern on the part of National Grid? A. Yes.

27 Q And one of the ways in which National Grid proposed to Ofgem to protect itself against the
28 risk of stranding was through the introduction of lower prices in conjunction with a
29 termination charge for meter replacement? A. Yes.

30 Q And your evidence, if we look at para. 10 of your statement is this:

31 "Ofgem's very clear and explicit view throughout the discussions with National Grid was
32 that there was no basis for compensating or protecting NG from the risk of stranding."

33 Do you hold to that statement? A. Yes.

1 Q Premature replacement, as regards premature replacement, if we look at para.14 of your
2 statement, and see what your evidence is here. Your evidence is that the concern in Ofgem
3 was over “a large scale replacement of fully functioning meters by identical meters over a
4 very short period”. So you have introduced there a number of specific qualifications –
5 “large scale”, “identical meters”, “very short period”? A. Yes.

6 Q Those were Ofgem’s only concern? A. That was certainly the focus of our concerns.

7 Q You refer in your statement to this very fast and very widespread replacement as we see
8 from para.15 as “undue premature replacement”, and you distinguish undue premature
9 replacement from “mere premature replacement” about which you were not concerned?
10 A. That is correct.

11 Q You say at para. 14, in the last sentence or two that these concerns of Ofgem’s arose
12 because such a large scale replacement “..would cause customer confusion and might be
13 seen by customers as a pointless exercise”; and “... it might have made the public less
14 receptive to the market reforms which Ofgem was overseeing.” So you mention here only
15 issues of customer perception and PR. You do not mention concerns based on economic
16 efficiency or perverse incentives, that is right is it not? A. Our assumption was in terms
17 of economic efficiency that if you are operating in the market the market will sort that out in
18 due course so what we would have expected to happen would be that National Grid would
19 reduce its prices in order to prevent inefficient – in an economic sense – replacement
20 happening. What we were worried about was that there might be a short term over which
21 that did not happen, and that the customer disruption associated with that if everybody went
22 on a hell for leather replacement. As we heard yesterday, there was a lot of bluff and
23 misleading information going on around that time, and so there was a concern that things
24 might happen at a really rapid pace which would not allow for normal functioning of a
25 market to yield what is an efficient outcome, and that is what markets deliver.

26 Q Why would it not happen in the short term? A. Well that is one of the questions we were
27 asking in some sense, and trying to understand why it would not happen in the short term.
28 One possible reason being that National Grid would tenaciously hang on and not want to
29 reduce its prices until it really felt that it had to, and therefore there might be undue
30 premature replacement happening.

31 Q But in your Decision you expected that National Grid might well wish to continue charging
32 at the price cap level ---- A. Yes.

1 Q -- over time? A. And if it did it would probably lose market share quite quickly, that was
2 its choice and I think that is not what we would expect to have happened, but that is one
3 possible outcome.

4 THE CHAIRMAN: What did you have in mind at the time as to the likely difference in price
5 between the P&M contract price capped rate and the competitive price of the meter? A. I
6 am not sure I can really remember. I think the CMO prices were something like £5 a year
7 cheaper and we would have expected that ultimately National Grid would have to move
8 down to something close to that level but may ultimately be able to retain a slightly higher
9 level than that, because there would not be the customer disruption associated with having
10 to go in and suppliers getting the customers to take the morning off work to have the meter
11 changed. So from a supplier's perspective we would again expect them to have an interest
12 in avoiding customer disruption but we are not wholly convinced that that seemed to be
13 coming through at the beginning from the words that we were hearing around the market
14 and the industry.

15 MR. TURNER: Were not wholly convinced that that appeared to be coming through at the
16 beginning, so you foresaw that suppliers were not necessarily safeguarding customers'
17 interests in avoiding unnecessary disruption. A. These were all questions that we were
18 trying to understand in the early stages of the market opening up, one heard all sorts of
19 conflicting stories and we were trying to understand what was going on.

20 Q Is it your evidence that suppliers can be relied on to protect the interests of customers by
21 avoiding premature replacement and customer disruption? A. I believe that that is the
22 case. I mean, there is a sense in which there are only six suppliers, and if they are all going
23 down the same track then it may be that they are not going to lose out to other suppliers if
24 they are all signed up to the same contracts on the same terms. But, clearly, you know, our
25 philosophy is that of a competitive supply market, in which case we rely generally on
26 suppliers to take account of customers' interests.

27 Q Quite. Now, returning to your statement, at para. 17 we see your personal position. While
28 you had some sympathy with the concern about undue premature replacement, you
29 expected that the market, given time, would find its own solution. A. Yes. Sorry. I
30 haven't got the paragraph ----

31 Q Paragraph 17, p.977 of the bundle numbering. That is your evidence. A. Yes.

32 Q Now, can we turn to your exhibit MF2 at p.1013? We are now in April 2002. We have a
33 note of an internal Ofgem meeting of the Metering Strategy Project Board. Is this a copy of
34 your note? A. Yes.

1 Q In the middle of the page we see the sentence to which you have referred in your statement
2 under ‘Gaullist approach of NI/Italy’,
3 “Iain, Customers having meters ripped out unnecessarily is nightmare scenario”.
4 Who is Iain? A. Iain is Iain Osborne who was then director of supply.

5 Q You say in your statement in the text that the concern over undue replacement was voiced in
6 particular by Mr. Osborne and his team. A. Yes.

7 Q The concern expressed in this note, however, is simply about meters being ‘ripped out
8 unnecessarily’. I see no reference to very large numbers of meters being ripped out or to a
9 programme of very rapid replacement. Do you? A. I don’t, but Iain’s focus was very
10 much on, “What were the consumer groups going to be saying about this, and how would it
11 play?” He had the team that managed consumer complaints coming into Ofgem. So, his
12 focus was going to be, naturally, a short term one - if there are pictures in the press of piles
13 of unused meters, or Mrs. Smith saying, “I took the day off work and I had to take it off
14 again six months later to have an identical meter fitted”. So, his concerns would’ve been
15 around the immediate impact on consumers.

16 Q Let us look down the page. There is something you have written there - ‘Principles’. The
17 first bullet, “No ripping out”. Then, “Not perverse incentives”. Do you see that? A. Yes.

18 Q Now, by that did you mean perverse incentives for suppliers to engage in premature
19 replacement? A. I can’t remember from the detail of the -- the limited detail in the notes.
20 I mean, there is a general concern about making sure that there are not perverse incentives,
21 as you say, for suppliers to take out meters prematurely.

22 Q How would such perverse incentives for suppliers come about? A. Well, the one that we
23 tackled subsequently was business rates where there was an artificial cost applied to
24 National Grid which meant that their prices were artificially higher than anybody else’s.

25 Q Can we deal with the one here at this time though - before that issue arose? A. Well,
26 these were principles. So, I’m not sure whether there was -- I really can’t remember what
27 the discussion was, I think is the honest answer.

28 Q Fair enough. Now, the first meeting the National Grid which you talk about in your
29 evidence, took place in April 2002. The reference is para. 30 of your statement. If we turn
30 to para. 30 we see that you give a description of that meeting there in the form of a series of
31 bullet points. Do you see that? A. Yes.

32 Q The first one is, “National Grid said it would not sell assets in situ”. What assets are we
33 talking about? A. Its metering assets.

1 Q Is your evidence that that is what National Grid said at the meeting? A. That they
2 weren't willing to transfer assets -- That is my evidence.

3 Q Let us look at the minutes of the meeting for a moment. There are two sets of them attached
4 to your statement. There is your handwritten note which is at MF5. There is a typed-up and
5 manuscript version. Then you also exhibit National Grid's note which is at MF6,
6 immediately behind it. Do you have those? A. I do.

7 Q What you say in your statement is that your description of these events is based on both sets
8 of minutes.

9 Q Yes.

10 Q Let us have a look at your note of the meeting at MF5. Look at the second page of the note
11 at the top. Do you see that first line: "Transco will not sell assets in situ". A. Yes.

12 Q Now, is that the basis of your recollection that National Grid said it would not sell assets in
13 situ, do you think? A. Yes.

14 Q Well, let us look at the other record of the meeting which you have also read and referred to
15 by National Grid at MF6, which begins at p.1089. Can we look at p.1091? Do you have
16 that? There is a heading 'Meter Separation Implementation Timetable'. Then it reads,
17 "Ofgem stated that they have received 'industry feedback' which attributes the
18 continuing industry delay to implement metering competition in large measure on
19 Transco's 'frustrating' policies. JD cited the following 'policies' ----"
20 Who is JD? A. Jonathan Dixon.

21 Q He is an Ofgem official? A. Yes.

22 Q The first policy that he refers to attributing to National Grid is Transco's refusal to trade
23 meters in situ. A. Yes.

24 Q So, we see here that Transco's alleged refusal to trade meters in situ is an issue being raised
25 by one of the Ofgem representatives at the meeting? A. Yes, based on discussions that
26 we'd had and things like the TXU letter which is also in my evidence.

27 Q Shall we see what National Grid said about the sale of its meter assets immediately
28 underneath that? Do you have that? "Trading meters." Each of the above policies was dealt
29 with in turn.

30 "Trading Meters. SJ [Stephen Johnson from Transco] confirmed that there is
31 currently no policy in operation to trade meters. This is not the same as there being
32 a policy not to trade meters. Transco has been and remains willing to discuss the
33 sale and purchase of in situ meters, however the difficulty so far is the difference

1 between the basis under which meter investment has historically taken place, the
2 forward-looking costs, and therefore the potential stranded investment”.

3 So, we see an articulation of National Grid’s difficulty with the question of sale of in situ
4 assets comes down to their value in this situation. Do you see that? A. Yes.

5 Q You accept that as an accurate statement of what was said? A. Yes.

6 Q If we turn to the bottom of that page, you come in at the last sentence:

7 “MF accepted that the basis upon which meter investments were historically made
8 were different now to then”.

9 You cited examples such as ‘meter manufacturer prices were higher then’. So, that is
10 presumably what you said at that time as well. A. Yes.

11 Q Just focusing on your statement there at the foot of that page, do you accept that in the
12 normal commercial metering environment, providers may address such risks - risks of
13 prices coming down over time and their investment being stranded - by making contracts
14 with cancellation charges? That is a feature of normal competition. A. Yes, with those
15 terms being imposed before the investment is made. So, in some sense it is a reasonably
16 objective justification for what otherwise might be – it’s a long term contract with
17 termination clauses, but it’s justified by the fact that if they didn’t have those clauses in
18 place they wouldn’t invest. So that is a normal feature of the competitive meter operators’
19 contracts, yes.

20 Q The company has to have had the opportunity to put those in before it makes the investment
21 obviously. If it does not have that opportunity then it cannot include such clauses?

22 A. Yes.

23 Q Let us turn to the Ofgem strategy for metering, an important document, May 2002, MF4,
24 exhibited to your statement. So we go past the April meeting and we now have the
25 publication of your report on progress and next steps. Is it right that as director of metering
26 at the time you would have been involved in preparing this document? A. Yes.

27 Q You are identified, I think, as the person to whom respondents should send their comments
28 on this document as well? A. Yes.

29 Q Mr. Mark Baldock is also referred to somewhere. Could you explain briefly what Mark
30 Baldock’s position was? A. Mark Baldock was head of metering, he reported to me. He
31 wasn’t an economist so he tended to deal more with the practical issues around RGMA
32 implementation and the project management and didn’t contribute a lot to the thinking
33 around the assets, which I led on more with the support of the economists on the team.

1 Q For the Tribunal’s reference the page I am referring to is 1032 where you see specifically at
2 para.1.11 that respondents to the consultation are meant to provide comments to Maxine
3 Frerk, and at 1.10:

4 “If you have any questions about the issues raised in this document, or the
5 Metering Strategy more generally, then please contact Mark Baldock or Jonathan
6 Dixon or Adrienne Monroe.”

7 Chapter 1 of the report I am ignoring, it is purely introductory. Chapter 2 is important
8 because it sets out the context of the report and begins with an explanation about how
9 competition in metering is expected to benefit consumers. Can you look at paras.2.4 and
10 2.5. Do you have those? A. Yes.

11 Q Can you read those for yourself. A. (After a pause) Yes.

12 Q Can I summarise: Ofgem’s thinking essentially is that gas suppliers can be expected to
13 force down prices and improve the range and quality of services to the benefit of end
14 consumers? A. Yes.

15 Q Given competition downstream, the gas suppliers are going to pass those benefits through to
16 end consumers? A. Yes.

17 Q Then we come to para.2.6 which you refer to explicitly in your statement at p.1034:

18 “In this context, it will be important to ensure that the delivery of metering
19 competition, which, in some sense, will be invisible to end consumers, does not
20 prejudice wider supply competition. Ofgem are also actively considering issues
21 relating to meter assets to prevent suppliers having an incentive to undertake
22 inefficient meter replacement programmes to acquire market share from the
23 dominant incumbents. This issue is considered further in Chapter 4.”

24 Pausing there, Ofgem’s concern is expressed in terms of gas suppliers having incentives for
25 the inefficient replacement of meters? A. Yes.

26 Q And Ofgem recognises that metering competition would, in a sense, operate invisibly to end
27 users – yes? A. Yes.

28 Q Just understanding what you meant there, if meters are replaced prematurely that is not
29 invisible to end users, is it? A. No, but the end users would not necessarily understand
30 that that was to do with metering competition and they wouldn’t know who was providing
31 their meter. They would know that they had to stay at home to have their meter replaced.

32 Q Metering competition would operate invisibly on that basis if National Grid drops its rental
33 charges for the installed assets because of the threat of the replacement – that would be
34 invisible? A. Yes.

1 Q It would also be an invisible operation if you have competition for new business at the time
2 when meters are replaced in the natural course because they have come to the end of their
3 lives, or other meter work is required? A. Yes.

4 Q Can we return to this document. The issue which you develop at greatest length in chapter
5 4 is stranding. Can we go to 1067 of the document. This is in chapter 4 entitled “Meter
6 Assets”. We have the heading on the right hand page “Stranding”. Do you have that?
7 A. Yes.

8 Q The definition of stranding is at 4.8, and we have covered that. At 4.9 we see that many
9 industry participants have expressed concern about the issue. 4.10 distinguishes between
10 two different kinds of stranding, the kind which results from reduction over time in the cost
11 of meter provision; and the kind which is stranding because of the introduction of
12 competition which leads to your asset being taken out? A. Yes.

13 Q So that the costs of the investment are stranded? A. Yes.

14 Q Ofgem then recognises a number of ways in which stranding and premature replacement
15 can be reduced or avoided, normally by providers, does it not – para.4.12? A. Yes.

16 Q At 4.12 we have:
17 “... absorbing the costs of ‘*stranding through reducing meter costs*’ and pricing at
18 a market level. Transco and the DNOs ...”
19 “DNO” stands for? A. Distribution network operators, so the equivalent in electricity.

20 Q “... could minimise the likely level of premature meter replacement and hence the
21 costs of ‘*stranding through competition*’.”
22 A. Yes, and we observed what happened in a market where, if you have got an outdated
23 technology and somebody comes in with a cheaper way of making a good, then what you
24 expect to happen is that you will then have to price your product in line with the more
25 efficient production or the newer technology in order to continue to compete.

26 Q So you can drop your prices to a level which is determined by competition in the market?
27 A. Yes.

28 Q Then if you look at 4.15, we have Ofgem returning to the possibility for National Grid,
29 Transco, to avoid stranding through price reductions. We have the point which I think you
30 referred to a little while earlier in the last sentence, after referring to the concern that:
31 “... suppliers will seek to replace meters before the end of their useful life causing
32 unnecessary customer disruption and economic inefficiency. In a competitive
33 market Transco could be expected to respond to this threat by reducing their price

1 to the market level – but in the short term, as competition is just emerging, may not
2 do so because their prices are not yet under sufficient pressure.”

3 A. Yes.

4 Q 4.15 contains no mention of this undue premature replacement. The problem is framed in
5 terms of replacement of meters before the end of their useful life? A. I think that’s
6 because I was saying that in the longer term you expected it to be sorted out and so the
7 undue bit, which is it happening in the short term before everything has been addressed is
8 the bit that we were particularly concerned about.

9 Q 4.13 of this report is then describing various other methods in which you can avoid
10 stranding in a competitive market, and we see that it says that: “The issue of stranded
11 meter assets is only likely to be relevant during the transition to competition.” So actually
12 in the normal competitive market you would not expect this problem to exist? A. You
13 would expect the CMOs to do something before they made that investment to ensure that it
14 was secured in some way.

15 Q So we are really concerned here with some transitional, some strange problem resulting
16 from the transition to competition, when you are talking about the problem of stranded
17 assets? A. Well in part 4.13 was intended to send a signal to the rest of the world that we
18 actually believed it should not be a problem going forward because there were those in the
19 industry who were saying that nobody will come in and invest as a competitive meter
20 operator, because they will be worried about stranding, in particular if customers switched
21 between suppliers for example. So what we were trying to do there was, first, signal that we
22 did not think that should be an issue going forwards, but to focus that the real debate and the
23 issues that we were discussing and on which we were interested in views which was around
24 the transition with National Grid.

25 Q How do you see people contracting as meter providers in the normal competitive
26 environment? What sort of contracts do you see them as competing for? A. What sort of
27 contracts?

28 Q How do you see them contracting for the provision of their meters in a competitive
29 environment? A. Well the contracts that we have seen have termination clauses, or
30 premature replacement charges built in in most cases.

31 Q What do they do? What do they achieve? A. They ensure that the competitive meter
32 operators, as far as possible, recover their investments that they have made in those meters.
33 They have other issues in different ways, so, for example, my understanding is that the risk

1 of faulty meters is addressed by passing that risk back to the meter manufacturer, for
2 example. So they would look in various ways at how to mitigate their risks.

3 Q Consistently with what you say, if we then look at 4.13, we see the three ways that you
4 describe that meter service providers in a competitive, commercial metering environment,
5 might act to avoid stranding. So we see first up front cost recovery and by that you mean a
6 charge, the time the meter is first supplied to cover the costs of procuring and then installing
7 it? A. Or just installing it, or some element of it, yes.

8 Q Then we have cancellation charge levying, if the meter is removed prematurely? A. Yes.

9 Q To recoup or cover the costs there? A. Yes.

10 Q And we also have setting higher prices to reflect the risk of losing a customer? A. Yes.

11 Although meters last for 20 years I think there is a question about whether you would have a
12 20 year contract for something where you have technical innovation and might accept that
13 you were going to lose that customer, or that you might expect suppliers to switch between
14 providers, so you might build that into your price, is one way that you could tackle that.

15 Q You would simply compete the business by offering the higher price to the customer?

16 A. I think if across the market everybody recognised that their assets were only going to
17 last for five years and not 20, then everybody's prices would reflect that. You might have
18 some who offered a lower price and a termination charge, some who offered a higher price
19 and no termination charge, and it is quite possible in a competitive market you would get
20 different structures of prices for customers to choose between.

21 Q And all of this is what you mean when you say in your statement that, given time, you
22 expect the market to find its own solution? A. Yes, my sense is there are lots of
23 industries that have long lived assets and companies find ways of pricing and addressing
24 those risks.

25 Q There is one part of your statement that particularly troubled us. You say at para. 23 – I do
26 not mind whether you turn it up or not – that Ofgem did not intend to suggest that these
27 strategies or approaches in 4.13 of the report, were ones which National Grid should adopt?
28 A. Yes.

29 Q According to you 4.13 is describing the steps open to new entrants? A. Yes.

30 Q There is nothing in 4.13 suggesting it does not apply to all meter service providers,
31 including National Grid, is there? A. I think the fact that there were some very explicit
32 paragraphs above that refer to National Grid and the particular issues that it faced as a result
33 of the whole artificial situation of having assets valued at more than they were really worth
34 in terms of their book value meant that there were particular things that we were saying

1 applied to National Grid, i.e. reduce your prices to a market level is the way to protect
2 yourself ----

3 Q Really? Can we look at para.4.19 on the facing page? We see here Ofgem actually
4 referring to the use by National Grid of one of the methods described in 4.13.

5 “With regard to installation, over the last few years up-front transactional
6 installation charges have been introduced to ensure that the costs for meters
7 installed subsequently will not be stranded.”

8 A. Yes, but that is not something National Grid could now do retrospectively for its
9 installed meter base.

10 Q Of course not, but Ofgem is there recognising that that is something National Grid has in
11 fact done, it did do that for meters installed after 2000? A. Yes.

12 THE CHAIRMAN: That is right, is it, what is written there, that there have been up-front
13 installation costs since April 2000?

14 MR. TURNER: That is for a category of meters, we will come to this, accounting for a very
15 small proportion of the total asset base. They are called “Category 2 Legacy Meters”, yes.

16 THE CHAIRMAN: Not as a general proposition?

17 MR. TURNER: No. A. I think I would say that I had a misapprehension at the time that I
18 wrote this document that it did apply to all meters, which only became clarified
19 subsequently.

20 Q At 4.21 we read this:

21 “... despite these recent changes the issue of stranding through competition still
22 exists in relation to the installation costs of domestic and I&C [Industrial and
23 Commercial] gas meters installed before 1 April 2000...”

24 that is when the up-front installation charges which you were referring to were introduced,

25 “... and 1 October 2000 respectively, as well as the installation costs of ...”

26 and then it refers to electricity meters. Then it refers to Transco’s present policy. So the
27 reference to the installation costs of domestic gas meters installed before 1st April 2000,
28 those are National Grid’s meters, to be clear, for which the issue of stranding exists?

29 A. Yes.

30 Q And the assumption must be that it was not simply wrapped up in the price control? A. I
31 have not said that it was wrapped up in the price control, I have said that it was
32 acknowledged in the price control and the decision was taken to not explicitly compensate
33 Transco or to move the element of stranded costs on to the transportation price control,
34 which would have been one way of dealing with it in the price controls, so we say that it

1 was acknowledged in the price control, small adjustments were made in the price control to
2 allow for it, but we have not claimed that it was solved through the price control.

3 Q Could you look at p.1074 finally, because these are your consultation questions resulting
4 from Chapter 4, under the heading “Replacement”. We see here the only two issues on
5 which Ofgem invites views in the May 2002 document. The first bullet:

6 “What regulatory changes”, you ask ...

7 “... are needed to ensure that alternative meter providers have an opportunity to
8 provide new meters when the old ones require replacement.”

9 Then:

10 “What regulatory changes are needed to minimise the incentives for premature
11 replacement?”

12 Now, does this not plainly show that Ofgem’s concern was not with the very rapid
13 replacement over a small number of years with the same technology, which you described
14 in your statement; the concern on which you are consulting is with avoiding replacement of
15 meters before the existing ones require replacement. That is what it says? A. Firstly, at
16 the beginning that paragraph, 4.35, we say we welcome views on any of the issues raised in
17 this chapter where we have signalled about expecting Transco/National Grid to reduce its
18 prices in the short term. So, I’m not sure I would say that this was necessarily a
19 comprehensive list of questions of the issues that we were concerned with.

20 Q These are the specific questions. A. These are the specific questions, yes.

21 Q Can you answer my question? Does this not clearly show that Ofgem’s concern was with
22 avoiding the replacement of meters before the old ones ‘require replacement’ and asking
23 what regulatory changes are needed to minimise the incentives for premature replacement?

24 A. These are issues that we were interested to understand people’s views on. I think that’s
25 rather different from us having ‘a concern’. So, if you say, “What was worrying me at the
26 time?” those are the issues that I was setting out in my witness statement, about the short-
27 term issues. We were trying to understand the whole regulatory framework and make sure
28 that we had a regulatory framework that was fit for taking us into a competitive market; did
29 not have perverse incentives. That obviously included the longer-term issues as well.

30 Q We have seen the position from Ofgem articulated in May 2002. Let us move forward. In
31 June 2002 you say that you attend a meeting on behalf of Ofgem with National Grid
32 representatives. Your preparatory notes for that meeting are at Tab MF7, p.1097. Do you
33 have those? A. Yes.

34 Q These are your notes then that you prepared prior to the meeting. A. Yes.

1 Q Let us have a look at what you say. You first describe the problem. You identify that it has
2 three components. First, you note that the charges based on RAV (Regulatory Asset Value)
3 of the Legacy meter stock are higher than the market prices. That must mean the market
4 prices prevailing for new meters. A. Yes.

5 Q Then, you have an arrow - that that can lead to rip out meters. The result of that is that it is
6 likely to lead to the ripping out of existing meters. A. Yes. It creates that incentive, yes.

7 Q Second, you identify as part of the problem no compensation for these stranded assets. Do
8 you see that? A. Yes.

9 Q You viewed that as part of the problem. A. Yes. I guess if National Grid had been
10 given some compensation, then it would've been happy to reduce its prices.

11 Q Then we have, "Transco better to have a few ripped out than --" Down arrow. Presumably
12 dropping the price ---- A. Reduce prices.

13 Q "-- on all of them." So, in other words, the final part of the problem is that National Grid's
14 incentives - and you are quite right here - may be to keep prices at the high price capped
15 level to seek to recover as much of the unrecovered costs as they can. A. Yes.

16 Q So, in the language of the 2002 strategy document from May, National Grid would seek to
17 reflect the risk of losing a customer in its prices by pricing as high as it can do compatible
18 with the regulated price caps. It cannot go above them -- It cannot raise them above that
19 regulated level, but that is its strategy. A. Yes.

20 Q Inevitably, that will trigger the premature replacement of meters from National Grid's
21 Legacy meter stock. A. Yes.

22 Q Your note then identifies premature replacement arising from this dynamic as a problem.
23 A. Yes.

24 Q The problem is framed in terms of a few meters being ripped out - not the large scale and
25 rapid undue premature replacement that you refer to in your statement. A. (After a
26 pause): I mean, this is my doodling in personal brainstorm mode in my notebook. I
27 suppose, looking back, trying to read back into how I was thinking at the time, that is how
28 Grid would've seen it.

29 Q So, let us look at the options that you thought would address the problem? It is immediately
30 underneath. Do you see the bottom option - 'Cancellation Charges'? A. yes.

31 Q So, you are identifying cancellation charges as an option for addressing this problem of
32 National Grid's Legacy meters being prematurely replaced. A. Yes, whether it was as an
33 option that we thought Grid might raise, or one of the options that's around in the area, yes.

1 Q That is the same option referred to in para. 4.13 of the May document which was published
2 in the preceding month. A. Yes.

3 Q Can you therefore maintain what you say in your statement that para. 4.13 was not intended
4 to suggest options properly available for National Grid? A. One of National Grid's
5 arguments at some stage in the administrative proceedings was that we had, in some sense,
6 actively encouraged or suggested to them, in a very pro-active way, that they should
7 introduce premature replacement charges. My statement says that the reference in the May
8 document was not intended as a signal to Grid, "Go away, and introduce premature
9 replacement charges". It was a general statement of the options that were available. So,
10 what I was trying to set out in my witness statement was that we weren't telling National
11 Grid to do this; we were highlighting the range of options that were around in the market
12 place, and that these were the kind of things that were being debated across industry at
13 large.

14 Q Now, I think you specifically invited National Grid - you used the word 'signal' - to come
15 forward with (your words) 'creative solution' to the problem of premature replacement of
16 meters, did you not?

17 A I think it was Grid that were more anxious than we were on the grounds that they were very
18 worried about their stranding ; they kept asking us to re-open the price control. What we
19 were saying was, "Don't keep banging on about us re-opening the price control. Go away.
20 If you can come up with some other creative idea, then do so and we'll think about it".

21 Q Can we just turn to where you said that? Go to MF12 at p.1133. (After a pause): We
22 might look at this again. This is an e-mail from yourself - 'Letter on metering strategy
23 forwarded'. In the first paragraph,

24 "To see the attached letter from Transco which follows up on the meeting John
25 Neilson and Andrew and I had with them, where we invited them to come up with
26 a creative solution to the problem of premature replacement of meters but which
27 didn't involve re-opening the price control, and offered benefits to customers (not
28 just Transco shareholders) --"

29 Do you see that? A. Yes.

30 Q So, you are specifically encouraging them also to offer another way of addressing stranding
31 without re-opening the price cap. Yes? A. Yes.

32 Q If we go back to MF9 at p.1115, the first page is the typed-up version, this is the meeting of
33 28th June, 2002. There are various attendees, including Colin Shoemith. Under 'What
34 from them --' near the foot of that page, "Steps to ensure sensible replacement --" We will

1 come back to your use of the words ‘sensible replacement’. So, please, remember that there
2 are “Other ways to skin a cat.” So, presumably finding this creative solution without re-
3 opening the price cap -- This is what you meant when you wrote ‘Other ways to skin a cat’?
4 A. Yes. The beginning of that, as my note is probably meaningless to everybody else --
5 Very much the beginning of the meeting was all about how much stranding of the £500
6 million that you have referred to before as being a stranding concern for National Grid. So,
7 the meeting started with National Grid setting out their stranding issues - not with us setting
8 out our concerns about premature replacement.

9 Q Yes. Just looking at that at the top of the page, now that you have hit on it, there is a line,
10 “until stranding solved – take more defensive issue”, and then “RAV £1.5bn of £1bn current
11 value”, then “£500m invested efficiently etc”. What do you take that to mean, £500m
12 invested efficiently” – what was being said there? A. National Grid were saying that the
13 £500 million of stranded assets that they felt were invested efficiently at the time, i.e. it was
14 reasonable for them to look to recover that, was their argument.

15 Q Would you agree with that? A. Well, our argument, as we keep repeating throughout,
16 was that it was an issue that had been considered during the price control and we weren’t
17 going to come back to it.

18 Q Would you agree at least that the 500, or whatever the level is, the outstanding past
19 investment was efficiently incurred investment? A. At the time, yes.

20 Q After this meeting on 28th June, we have National Grid responding to your invitation to
21 come up with creative solutions. This comes in the form of a letter which is sent to you on
22 6th August, which you have also attached to your statement, and that is at p.1134 in MF12.
23 Can we have a look at that. It is dated 6th August 2002. Do you have that, “Dear Maxine”?

24 A. Yes.

25 Q Let us have a look at the third paragraph beginning:

26 “The main aim of our proposal is to reduce the current incentive to prematurely
27 replace meters, which is inefficient, may lead to unnecessary disruption for
28 consumers and may discourage future investment. Transco has considered a
29 number of possible ways of encouraging efficient replacement and believes that a
30 methodology based on premature replacement (cancellation) charges would be the
31 simplest, most transparent and most effective approach. In a commercial metering
32 market, we would expect that other meter operators would also adopt this
33 approach. As set out in the paper, the level of the payment would reflect

1 unrecovered provision and installation costs. This approach clearly signals the
2 costs associated with replacing the meter before the end of its useful life.”

3 So National Grid has settled on the option which you have identified in your preparatory
4 notes for the June meeting of the cancellation charge – yes? A. Yes. I think it is fair to
5 say, and it is in one of the other internal emails from National Grid, that when we talked
6 about cancellation charge we were not necessarily thinking about something that would
7 ensure the full cost recovery. You can have a cancellation charge that is of a nominal sum.
8 So it is not necessarily the same as a cancellation charge ----

9 Q It is a lower level than necessary to entirety of the past investment? A. Yes.

10 Q Such as under the MSA agreements? A. Yes, or much lower than that.

11 Q In the fourth paragraph of this letter National Grid says:

12 “The introduction of premature replacement charges would be linked to a reduction
13 in annual metering charges.”

14 Do you see that? A. Yes.

15 Q “The level of the proposed reduction strikes a balance between allowing Transco to
16 earn a reasonable return on its investment in metering and enabling all shippers to
17 share in the benefits of competition by way of an immediate cut in their metering
18 costs.”

19 Pausing there, that appears consistent with the indication you gave at the June meeting that
20 National Grid should ensure a pass through of benefits to consumers? A. It’s responding
21 to that. Obviously much of the discussion that we had on the way through subsequently
22 was for us to say that we didn’t think that the level of reduction proposed was anything like
23 a satisfactory compensation for customers.

24 Q It was not big enough? A. It wasn’t big enough.

25 Q We will come to that. Also in the fifth paragraph National Grid notes that this proposed
26 reduction in its charges is going to lead to significant levels of stranded costs? A. Yes.

27 Q So National Grid is saying to you, is it not, “We are proposing to reduce our prices below
28 the level of our regulatory asset value base charges so as to minimise the likely level of
29 premature replacement – yes? A. Yes.

30 Q That is exactly as Ofgem had invited it to do in para.4.12 of the May 2002 strategy for
31 metering, reduction in price? A. It was still significantly higher than market prices.

32 Q It would yield, this reduction, the benefits of competition in a way invisible to end users?
33 A. Yes.

1 Q Your email reacting to this letter is on the first page. We looked at that a moment ago. You
2 say after the bit that we referred to before:

3 “It had always appeared to me that a cancellation charge was a potential way
4 forward – however we would need to look at the fit with price control (i.e. if
5 certain charges are capped you can’t just get round the control by introducing some
6 other charges) and the impacts on competition (this is a barrier to switching
7 supplier – but since the problem that we are worried about is that of inefficient
8 switching maybe we shouldn’t be worried about it ... also if we get lower charges
9 generally then this is a benefit).”

10 So your initial reaction is to doubt whether there is a need to worry about premature
11 replacement charges if they stop the inefficient switching of meters? A. I think you can
12 see me almost mentally putting down the pros and cons, and certainly when we talked to
13 Grid about it one of the suggestions we made was, could this be limited to five years. So
14 again that comes back to the fact that the concerns were about inefficient switching over the
15 initial short term period.

16 THE CHAIRMAN: Could what be limited to five years? A. Could the proposed contract
17 terms be limited to five years. Our concern was that this would look like a very long term
18 contract.

19 MR. TURNER: That may be anticipating things, Mrs. Frerk, because we see nothing of that in
20 this at this stage, do we? A. No.

21 Q A little bit later on you say, your last but one bullet:

22 “Ultimately the test is whether the changes are acceptable to shippers (suppliers).
23 – the Transco letter still refers to compensation for the stranding of assets – it is not
24 clear what they are envisaging but I would see the cancellation charges as a quid
25 pro quo for the lower rental (i.e. no further compensation justified).”

26 There are two points there. First of all, compensation, we are talking about the price
27 control, and Transco seeking also to get compensation via the price control? A. Yes,
28 because their letter said this proposal was conditional on us providing compensation.

29 Q You say:

30 “Ultimately the test is whether the changes are acceptable to shippers (suppliers).”

31 So if the gas suppliers are strongly in favour of National Grid’s proposal that would at least
32 be a significant factor in your view? A. It would be. That was my initial reaction.

33 Obviously as we went through the discussions we subsequently made it very clear that we

1 would be interested in the views of the CMOs as well, so it wasn't just the shippers. But at
2 that stage that was my headline reaction when I first saw the letter.

3 Q We will no doubt see that in due course. You then send another email about National
4 Grid's proposals to your colleagues in Ofgem in August, on 21st August. In para.42 of your
5 statement ---- A. Which page is that?

6 Q Can we go first to the statement at para.42. The reference is there, it is going to the MSA
7 team. What you say about it is that you subsequently sent an email to your colleagues in
8 which you outlined some of the competition concerns "which we had with the proposals" –
9 yes? A. Yes.

10 Q So let us look at it now, MF18. Here is your email of 21st August "Letter on Metering
11 Strategy", and you say in the second line:

12 "I was very careful in the meeting not to comment on Competition Act issues,
13 except to say they would need to make their own assessment, which they claimed
14 they had, and were happy it was okay."

15 Then in the second paragraph, what you are doing is set out your own thoughts on the
16 competition issues.

17 "My own instinctive view is that it is hard to see how a cancellation charge on this
18 scale would not have an effect on competition, but the competition it would be
19 affecting would be an area where we anyway have concerns about the detrimental
20 effects on consumers of premature replacement of meters, and this would address
21 those concerns."

22 So, pausing there, you recognised that the competition affected would be inefficient
23 competition – competition to replace meters prematurely harming consumers? A. Sorry,
24 could you repeat the question?

25 Q The competition, what you are saying here, it would be affecting would be inefficient
26 competition because it relates to competition for the premature replacement of meters, and
27 this would address those concerns? A. Yes, I do not think I use the word "inefficient"
28 there, do I? Obviously people have lots of different views about what is meant by
29 "inefficient".

30 Q You then wrote to National Grid on 2nd September 2002 and we can look at that at MF19,
31 the following tab. This is the first formal communication, September 2002, of Ofgem's
32 views at that stage of the process, as opposed to your personal views as expressed in the
33 earlier meetings. We see that because you are now talking about "we" throughout this, so in
34 the second paragraph we see: "We might also wish to consult ...", "Any comments we

1 make now are therefore provisional ...”, and then below that: “At the meeting we raised a
2 number of concerns ...”? A. Yes, at that stage this had not been discussed by our
3 Management Committee, so although I was obviously writing formally on behalf of Ofgem,
4 these were still very much in those ----

5 Q Not with the fiat of the Management Committee, I understand that. Now, in the first
6 paragraph you are referring to the presentation of a proposal for a premature replacement
7 charge, together with a reduced annual rental, to address the problem with asset stranding,
8 raised in Ofgem’s consultation on its metering strategy. So that is the May 2002
9 consultation? A. Yes.

10 Q So you are acknowledging here that the May 2002 report is raising problems with National
11 Grid’s asset stranding? A. Yes, we discussed those issues.

12 Q If we turn to the second page of the letter, and under the indent in the paragraph beginning:
13 “We made it clear ... that we would not contemplate any compensation ...” and you can
14 take it as read we are talking about the price control there. We have the sentence, the last
15 sentence in that paragraph:

16 “In our view, the benefits to Transco of the reduced rental charges would come
17 through the introduction of the premature replacement charge which would give
18 Transco some protection against a certain level of stranded costs which might
19 otherwise result through competition.”

20 That was your position - yes? A. Yes.

21 Q Go back to para. 10 of your witness statement and look again at the first sentence, where
22 you said:

23 “Ofgem’s very clear and explicit view throughout the discussions with NG was
24 that there was no basis for compensating or protecting NG from the risk of
25 stranding.”

26 That was incorrect, Ms. Frerk, was it not? A. No, we still maintain that there was no
27 basis for compensating National Grid for stranding. National Grid were asking for
28 compensation for the reduced rental, so they were still asking for compensation for
29 stranding, even if it went with the proposed reduction in rental and we were saying there is
30 still no basis for that compensation and, in some sense, you have already got part of what
31 you are looking for in terms of the protection against stranding if you go ahead with your
32 proposed price reduction and introduction of premature replacement charges.

33 Q I am not interested in compensation through the price control; I am interested in what you
34 said there about there being no basis for protecting National Grid from the risk of stranding.

1 If you look in para. 9, just above that, the penultimate sentence, we see exactly what is
2 meant. “Later, National Grid’s proposal to impose a termination charge for meter
3 replacement was designed to protect it against the risk of stranding.” And then your
4 comment in para.10 about no basis for protecting from the risk of stranding follows on from
5 that. At least to that extent, para. 10 must be wrong, Mrs. Frerk? A. I am not sure I quite
6 understand the question. We were not agreeing to these proposals because we thought it
7 helped National Grid’s stranding position, we were interested in discussing these proposals
8 because we were worried about the effect on consumers of premature replacement.
9 Obviously they are linked concepts, but if all it had done was protect National Grid’s
10 shareholders against stranding we were not interested in that proposition.

11 Q Let us return to the letter at tab 19? A. Yes.

12 Q Immediately under the sentence we have just read: “In our view the benefits to Transco
13 would come through the introduction of the premature replacement charge”, you go on then
14 to identify a number of specific matters which were of concern to Ofgem in relation to
15 National Grid’s proposal – that is on the first page: “At the meeting we raised a number of
16 concerns with the proposal ...”? A. Yes.

17 Q So we have concerns here relating to the level of the charge? A. Yes.

18 Q First, no recovery of installation cost where it has been recovered up-front – that is your
19 first indent. Second, allowance has to be built in for re-use value - yes? A. Yes.

20 Q Third, you express this concern that the charge should not act to deter innovation?
21 A. Yes.

22 Q I just want to pause there and ask you something. At this time the charges which National
23 Grid have outlined to you for premature replacement were age based charges of the sort
24 that Ofgem’s decision finds to be non-restrictive, were they not? A. I think what we find
25 is that they are less restrictive than the other charges; I do not think we would argue that an
26 age related PRC has no effect on competition.

27 Q “Consistent with normal competition” is I think the way it was put in the defence? A. It
28 might have been in the defence, yes.

29 Q Now, at tab 16, we can see the charges which were then on the table which you were
30 referring to with your concerns. They are at p.1184. Do you see those? A. Yes.

31 Q So we have a series of indicative premature replacement charges for credit meters, focusing
32 on table A1 and, depending on the year or the age of the meter, the charge declines all the
33 way down to £6.92 for a 20-year old meter. You have that? A. Yes.

1 Q What is it about the structure of these charges which would deter innovation? A. This
2 was us providing comments on some proposals that we had seen and had just under a month
3 in the month of August. My reaction was that it was not about the structure, it was about
4 the level, that they are very high and that the prospects of suppliers choosing to pay these
5 premature replacement charges at the kind of level that they suggested there was going to
6 have an impact on suppliers' willingness to replace these meters with smarter meters in five
7 or six years' time.

8 Q It is important, I want to stay with that phrase that you have just read: "these were very
9 high", let us move on for a moment. Going back to your letter, at the foot of that page, and
10 then over the top -- Would you like to read that indent? At p.1195, the last indent:

11 "Although our understanding is that currently suppliers are not looking to replace
12 meters other than when they are due for renewal or when other meter work is
13 required, and hence the impact on competition could be argued to be limited ----"

14 Do you see that? A. Yes.

15 Q It goes on,

16 "-- we would want to see some flexibility going forwards so that suppliers could
17 accelerate their replacement schedules in future without incurring penalties. As
18 currently envisaged, the proposed level of charges would probably make further
19 replacement uneconomic and hence would have the potential to distort
20 competition".

21 So, you envisage here that these charges, which we were looking at a moment ago, have the
22 potential to distort competition. Yes? A. Yes.

23 Q This is so, even though they have the age-based structure along the lines of the
24 counterfactual in the Decision and they decline progressively with their age down to a low
25 level and eventually to zero. Yes? A. Yes. It seemed to me that these kind of charges
26 would clearly present more of a barrier to suppliers selecting CMOs than if they continued
27 on the P&M charges. I thought counsel had said earlier in the hearing that they now
28 accepted that these charges did foreclose the market in the sense of limiting the amount of
29 competition that there would be, but the question was whether it was anti-competitive. To
30 me, at this stage, having had the proposals for three weeks, it looked to me that it was fairly
31 obvious that they were going to inhibit competition compared to the P&M contracts which
32 was what was currently in place.

33 THE CHAIRMAN: I think the point that is being put is that that was because of the level of the
34 charges rather than the structure of the charges. A. Yes, and I agree with that.

1 MR. TURNER: Can we look at the defence for a moment in CB1, at Tab 3? (After a pause):

2 Look at p.569. Paragraph 212.

3 “As noted in para. 4.161 of the Decision it was legitimate for National Grid to
4 seek to recover its customer-specific sunk costs, but this is not what it did in the
5 Legacy MSAs. National Grid may not have been able precisely to determine
6 unrecovered customer-specific sunk costs but [and I just want to look at this bit] it
7 could have calculated a reasonable estimate for the Legacy meter population as a
8 whole [that is the outstanding past investment], for example by subtracting from
9 the historic asset value, the re-use value of any meters if removed at the date of the
10 calculation. This figure could have been used to generate age-related PRCs. These
11 age-related PRCs could then have been tested in the market with the suppliers”.

12 That is Ofgem’s position in the defence about what could lawfully have been done.

13 Now, putting that away, and seeing what they say there about how they could have sliced it
14 up and generated age-based values, and what would have been lawful, if we go back on that
15 basis to the series of charges that we were looking at a moment ago on p.1184 in Tab 16,
16 can I ask you again: What is it about either the structure or the level of these charges that
17 would have had the potential to distort competition? A. I think, if I understand it, what I
18 am answering is what I thought at the time about those charges. I mean, in order to assess
19 whether or not they were anti-competitive would have required quite substantial evaluation.
20 But, at the time they did seem high to me, and they just raised questions that said, “Well,
21 you need to look at the competition impact of this”.

22 Q Would you have regarded it as a benchmark on this question that the level of these charges
23 reflected the costs recovery -- the recovery of sunk costs of outstanding past investment
24 such that if these charges had not been intended to recover more than the outstanding past
25 investment, the level would not have been objectionable? Was that your benchmark? A.
26 No. My position at the time was, as I have said, that I was not concerned and did not
27 believe at the time that National Grid had any right to recover even its customer-specific
28 sunk costs. So, I was working on the basis that they had no right to recover any of the
29 stranding and that this was purely about what might provide some kind of cancellation
30 charge that would perhaps temper the most excessive of premature replacement
31 programmes.

32 Q We have seen how it is put in the defence. But, returning to your letter of 2nd September, at
33 Tab 19 -- What you do in this indent is interesting, because you are asking National
34 Grid/Transco to give some flexibility, going forwards, beyond enough flexibility for

1 replacement of meters when they are due for renewal or when other meter work is required
2 so that suppliers could accelerate their replacement schedules in future without incurring
3 charges. Yes? A. Yes.

4 Q That is what you are asking them to try to build in. In other words, you are steering
5 National Grid to arrangements that would allow a level of replacement for free above and
6 beyond what is needed to deal with end-of-life and meter work replacements. That is what
7 you are saying. (After a pause): Let us look at it again, if you like, that paragraph. You
8 refer to the fact that currently the gas suppliers do not want to replace meters other than
9 when due for renewal or when meter work is required. You refer to that. A. Yes.

10 Q Then you say, after your brackets saying that competition impacts could be argued to be
11 limited.

12 “We would want to see some flexibility going forwards so that suppliers could
13 accelerate their replacement schedules in future without incurring penalties”.

14 A. Yes.

15 Q So, what you must be talking about is allowing some level of free replacement - no
16 penalties - beyond the level that you had anticipated they were referring to there. A. Yes.

17 Q Now, that was therefore very similar to the glidepath arrangement which National Grid
18 eventually does end up with in the MSAs, which does exactly that. (After a pause): It
19 allows for the replacement of a significant number of meters, fully functioning, beyond the
20 level required to be replaced as a result of them being due for renewal or when other meter
21 work is required. A. It’s coming back to where we were in the process at this time, which
22 was that we were signalling to National Grid that they needed to look at the Competition
23 Act issues in the round; that they needed to look at the Competition Act issues. We were
24 giving some initial thoughts on the kind of areas that they might want to think about, and
25 there was also the point that we would need to consult on these issues, which at that stage
26 was going to be through a ... modification.

27 Q I am not interested in the process, Mrs. Frerk. It is merely your thinking. What I am
28 showing you here is that what you were asking them to do -- what you said would be
29 needed is, in fact, what the MSAs ultimately delivered. Is that not right? A. I think that’s
30 what we’re saying was the minimum that was needed, and then you need to look at what the
31 impacts on competition are when you have done that.

32 Q So, you refer to this desirable level of flexibility that you also wanted to see above the level
33 needed to deliver this minimum number of replacements. To understand your thinking,
34 what is Ofgem’s benchmark for deciding the right level of flexibility in terms of free

1 replacements? A. I don't think I had a benchmark at the time, but my sense was that it
2 was going to be very hard for people to anticipate what they might want to do more than
3 five years out, and that they could want to do something very different.

4 Q I put the question in a slightly different way: If you are National Grid, by what lights do you
5 know that you have given away enough charge-free meters to satisfy your regulatory
6 objectives? How does it know? A. I think it's up to National Grid to satisfy itself that it
7 has met the Competition Act requirements and we were very careful here not to be telling
8 National Grid what it had to do. That is National Grid's responsibility to carry out that
9 assessment, and furthermore we would have had to consult in due course on any proposal if
10 it was put forward as a formal proposal to us under Network Code modifications.

11 THE CHAIRMAN: At this stage were we still talking about the Network Code modification
12 rather than a Competition Act situation? A. We were talking about a Network Code
13 modification, what I was aware of at the time, and my worry was that we would approve it
14 as Network Code modification, but that that could be seen as giving a blessing under the
15 Competition Act and what we were careful to do all the time was to say to National Grid,
16 "It is your responsibility to ensure that this is compliant with Competition Act".

17 MR. TURNER: Madam, Mrs. Frerk is absolutely right about that. At this stage, as you see from
18 the first page of that letter, her second paragraph begins, "As I indicated at the meeting, if
19 National Grid were to raise a formal Network Code modification", etc. (To the witness)
20 What I am exploring with you at the moment is, according to your regulatory thinking, you
21 said the price has to come down, that it had not come down enough, "flexibility has to be
22 given in terms of free replacements, you have not given enough", and what I am asking you
23 is how you, with your regulatory hat on, are setting a benchmark for these considerations.
24 How do you at Ofgem decide prices are now low enough, the amount of free replacement is
25 big enough? How is it done? A. At this stage we were very careful not to be giving a
26 concrete steer, because we had to take a formal decision under the Network Code. If that
27 had been done there would have had to have been a full evaluation done through the normal
28 processes, which involve industry consultation, an assessment of the impacts, cost benefit
29 analysis, or whatever, that would have actually set out and informed the decision that we
30 would ultimately have to be taking based on much more analysis than was being provided at
31 the stage of the discussions.

32 Q I completely understand the process, I just wonder whether you can help us at all on what
33 the thinking would be about how you would eventually decide the right level had been met

1 by National Grid. How is that done substantively? A. Well, we would be looking at how
2 much it had reduced and what the benefits were to consumers.

3 Q How do you know when it is enough? A. It was a difficult question that I wasn't really
4 looking forward to having to make.

5 THE CHAIRMAN: Can I just be clear. Is your evidence then at the time you wrote this letter
6 you did not have in mind any particular level of price or any particular number of extra
7 flexible replacements that would be acceptable to Ofgem? A. That's correct. I just
8 sensed that these looked very big cancellation charges. The level of discount at 50p per
9 meter per annum that was being provided didn't seem to us very substantial for the big shift
10 in risk that was being effected by the introduction of the PRCs.

11 MR. TURNER: You then have a meeting after this letter – that is, I think, 4th September – with
12 National Grid and at MF20, the next tab, we have got your note of that. Just to pick up on
13 Madam Chairman's question, we now see, two days later, half way down this page, one
14 bullet point, "Network Code – alternative of bilateral" – do you see that? A. Yes.

15 Q So National Grid is suggesting to you just after your letter that the proposal is implemented
16 by bilateral deals rather than the Network Code modification – yes? A. I certainly see
17 that there. I have, in my witness statement, said that the December meeting was the first
18 time they raised that, and certainly that is my recollection and very much the – my whole
19 memory was that that was a big shift in December when we discovered that it may not be a
20 Network Code mod. I can't disagree with the fact that that bullet point is there, but I can't
21 recall that discussion.

22 Q We can see that also from National Grid's note which you have also exhibited and referred
23 to at MF21. If you go to p.1208, which is the second page – I am afraid the only way to
24 read this, as with things that come out of cereal packets for children, is with a yellow
25 highlighter. You have to run it over the top paragraph and it says:

26 "Bilateral deals – Transco explained that it had been 'market testing' the proposals
27 with major shippers (although it could not name them due to confidentiality
28 commitments) and that there was a great deal of interest. Transco wondered
29 whether Ofgem had a view of progressing these commercial arrangements through
30 bilateral deals rather than a Network Code modification – they had not considered
31 the point and expressed no view."

32 Yes? A. Yes.

33 Q I do not think we need go back to it.

34 THE CHAIRMAN: It said "they had not considered the point", who is the "they" there?

1 MR. TURNER: That is Ofgem. So National Grid, here we are, 4th September, say to you, “We
2 could do it through the bilateral deal route”, and it is recorded also in Mrs. Frerk’s note at
3 p.1201 in tab 20. It need not detain us, but, therefore, as I think you were saying a moment
4 ago, it is not quite right that National Grid first floated the idea that the proposal might be
5 implemented by bilateral deals only in December? A. I agree, there is some sense in that.
6 That is an error in my witness statement. What I am saying is I know that we proceeded on
7 the basis that it would be a Network Code mod through until December where it became
8 very clear and, as I say, my clear recollection is that we had a shift in thinking at that point.

9 Q Can we stay on the National Grid note at tab 21, p.1207 – I am very sorry, it is the last
10 paragraph at the foot of that page, and it reads as follows:

11 “Compensation – Ofgem’s letter had confirmed their formal position. Transco felt
12 this position might undermine their enthusiasm to implement the proposals.
13 Ofgem were prepared to acknowledge that they would not be actively seeking to
14 minimise the value to Transco of any deal brokered with the market – i.e. if
15 Transco could find sources of value they could (probably) keep them.”

16 Do you see that, in so far as you are able to read it? A. Yes.

17 Q That reflected your position? A. I don’t recall saying that, but with the “probably”
18 caveats that are in there it may well be an accurate statement. We certainly weren’t going to
19 prevent National Grid from keeping the value provided all the other things that we did keep
20 repeating about impacts on customers and impacts on competition.

21 Q Let us go forward to MF22, which is National Grid’s letter to you after that of 25th
22 September. It begins on p.1213. National Grid is here replying to the letter of 2nd
23 September that we saw a moment ago. If we turn to the third paragraph we see National
24 Grid saying under the heading “Re: Premature Replacement Charges”:

25 “As we agreed, this letter sets out our response to the points that you have raised
26 and, where appropriate, makes alternative proposals.”

27 Do you have that? A. Yes.

28 Q So this letter is addressing in turn each of the points raised in your letter of 2nd September.
29 Dealing with your first concern relating to the PRC, please look under the heading
30 “Structure and Level of Premature Replacement Charges” – do you have that? A. Yes.

31 Q National Grid is explaining, if you read that, that a key consideration is that the charges
32 should be:

33 “... simple to understand and administer, thereby increasing transparency and
34 minimising implementation and administration costs.”

1 Pausing there, would you accept that those factors are relevant and legitimate considerations
2 when setting a structure of charges? A. Yes.

3 Q Your second concern relating to meters which had been subject to the up-front installation
4 charges about which madam chairman asked, if you turn over the page, p.1214 and look at
5 the first paragraph underneath the table:

6 “Transco is willing to give further thought to differential charges ...” that is reflecting that
7 issue, “... if Ofgem believes that the additional complexity would be justified by improved
8 cost-reflectivity.” Yes? A. Yes.

9 Q That is then followed up by you, just to complete this, with a question on how many meters
10 are actually affected, that is at MF28, p.1245. If you look at p.1245, heading 2, “Number of
11 Meters” you have in (a) Ofgem’s question reflected, the question of discussion with
12 Transco, the idea of having different charges depending on whether installation had been
13 paid for up-front, and the question:

14 “How many meters are there (and what proportion of metering assets do they
15 represent) for which one-off installation charges were made”,

16 and you got the answer:

17 “As at July 2002 (the latest date for which invoice data is available) about 420,000
18 domestic meters had been subject to one-off installation charges. This represents
19 about 2% of the 20.5 million domestic size meters.”

20 And you did not come back on that issue at any stage – I can tell you there is nothing in the
21 documentation – it is not a memory test.

22 National Grid also respond in their letter of 25th September back in tab 22, to your third
23 concern, that no account had been taken of the potential to re-use meters. Now you had said
24 in your witness statement, at para. 46:

25 “[National Grid] also said re-use was only possible for the newest meters, but it
26 made no attempt to allow for the effect even on those meters.”

27 Now I want to put it to you that that was rather unfair, because in fact National Grid did
28 give a number of good reasons why reuse was not feasible. If you go back to 1214, and you
29 look at the next paragraph down, beginning: “Ofgem also suggested that allowance should
30 be made for the potential re-use of meters by way of refurbishment”, they refer to three
31 things. First, reminding Ofgem that 75 per cent of the Legacy meter population are Imperial
32 meters, and that National Grid have agreed with Ofgem that they will not re-use those
33 meters. Secondly, that the opportunity to re-use metric meters would be limited in the
34 competitive market, where suppliers contract with other operators for new and replacement

1 meters. Third, and lastly, National Grid notes that the costs associate with re-use (such as
2 refurbishment costs) make it uneconomic for all but the newest meters.

3 So to place in context their answer, that is a complete statement of their position on re-use?

4 A. Yes.

5 Q Lastly, on innovation, we have your heading “3. Flexibility” on p.1214. We see that
6 broadly, National Grid is explaining that innovation can be accommodated if necessary
7 without premature replacement by fitting a device that allows AMR modules to be attached
8 to the existing meters? A. In some cases, yes.

9 Q Explaining that if suppliers want to replace the meters before the end of their useful lives,
10 and this is the last paragraph on 1214, this would increase Transco’s costs.

11 “Transco would wish to recover t hose costs, either from Ofgem by way of
12 compensation for stranding ...”

13 Leave that aside, I am not interested in compensation via the Ofgem route. “... or from
14 shippers through premature replacement charges or higher rental charges.” Now, as I say,
15 leaving aside compensation from Ofgem, the other two means of recovering one’s
16 investment are features one would expect to see in a commercial metering environment, are
17 they not? A. Yes, we have said they are.

18 Q You next meet with National Grid on 9th October, and if we turn to MF24 at 1224 we have a
19 letter that you followed up with on 11th October. Very briefly, this letter begins by thanking
20 National Grid for providing further information on its proposals “to address the problems
21 associated with stranding of assets” – that is how you are describing the problems. Then the
22 letter says that in the May 2002 document:

23 “... Ofgem identified that undue premature replacement of meters could be to the detriment
24 of customers.”

25 Mrs. Frerk, so far as we can see, this is the only time in all of the documents in which the
26 phrase “Undue premature replacement” ever appears. That is right, is it not? Certainly
27 none of the other documents to which you have referred in your statement; it is nowhere
28 else? A. I cannot recall whether it is the language we used at all in the May document.

29 Q It is not anywhere in the May document either. The next sentence after that, refers
30 explicitly:

31 “Our understanding is that Transco’s proposals are intended to reduce the
32 incentives for premature replacement.”

33 Just pausing there on the question of principle, what in your view is your benchmark for
34 deciding when premature replacement crosses the line and becomes “undue, how is that line

1 determined? A. Again, I do not think we had a single figure in our minds. The kind of
2 things that we know British Gas ultimately ended up doing, which is replacing meters over a
3 14 year life, rather than 20, would not have seemed to us as undue; if all meters were
4 replaced in five years that would have seemed to us as undue. Where the line falls between
5 that we did not ever really address.

6 Q So to summarise, what it comes down to is a point of regulatory judgment? A. Yes.

7 Q Let us turn to your briefing note then, prepared on 14th October 2002 for Callum McCarthy,
8 which you will find at MF25. Can we just clarify, who is Callum McCarthy at this time?

9 A. Callum McCarthy at this time is the chairman and chief executive of Ofgem.

10 Q And this is a briefing note which you send to him and to others on 14th October?

11 A. Yes.

12 Q This is a note designed to brief Mr. McCarthy on issues that the chairman of National Grid
13 might raise with him at a forthcoming lunch engagement? A. Yes.

14 Q Your briefing begins, and I am on p.1228, by explaining the issue – do you see that under
15 “Date issued”, the “Issue”.

16 “Transco face a risk of stranded assets if suppliers take out Transco’s meters early.

17 Transco want to mitigate this risk by introducing a premature replacement charge.

18 In an attempt to make this acceptable to us they have proposed, at the same time
19 reducing their annual charges to suppliers for providing meters – albeit with a
20 question as to whether they then expect compensation for that reduction.

21 The issue is whether a package along these lines would be acceptable to us.”

22 Do you see that? A. Yes.

23 Q Then we see from this that Transco have two distinct elements to their proposal. We see
24 that firstly we are talking about the imposition of premature replacement charges coupled
25 with reduced rentals, and then secondly the question of whether compensation is also
26 available from the reduced rentals through the Ofgem route? A. Yes.

27 Q And that is then the issue leading to your question of “... whether a package along these
28 lines would be acceptable to us”. So, we then move to the line, to the next row in your
29 table.

30 “We have not got a firm position on premature replacement charges but we will
31 continue to work with Transco on their proposals. For us to agree to any proposal
32 it would have to provide a clear net benefit to customers”.

33 That is in the fourth box down the line. A. Yes.

1 Q So, we see from this that you are talking about the provision of a clear net benefit to
2 customers. What benchmark would you have used to decide when enough benefit was
3 provided to customers? Again, is it just a question of regulatory judgment? A.
4 Regulatory judgment, together with any analysis -- cost benefit analysis, looking at the
5 transfer of risks, and the gains to customers, reduced customer disruption. So, we would
6 look in the round at the different elements and try to assess those in as objective way as we
7 could.

8 Q So, after setting out the line, the next bullet is referring to the price control issue and
9 whether that should be re-opened. I leave that aside. The next box is entitled 'Background'.
10 At the bottom of the page we read this:

11 "Since Transco's charges are in excess of those that would prevail in a
12 competitive market, there has been concern, which Ofgem shares to an extent,
13 about the inconvenience to customers and economic inefficiency that would occur
14 if in situ meters were replaced with other meters from a different provider".

15 So, pausing there, Ofgem is sharing, to some extent, National Grid's concern about
16 premature replacement. A. To some extent, yes.

17 Q There is a clear recognition of economic efficiency considerations - 'economic inefficiency'
18 it is described as - as well, alongside the concerns of customer disruption. A. Yes. As we
19 will no doubt come on to, those words were picked up by our chief economist. So, it was
20 me using it in very much a lay sense at that stage.

21 Q The final paragraph of this note, just above 'Further Information', "Ofgem's objectives in
22 reaching a conclusion on this are --" To look at them, the first bullet is to have in place the
23 right conditions for competition going forwards. A. Yes.

24 Q Is that your vision of the market and how it should look - the competitive metering market?
25 A. Yes.

26 Q The right conditions. Then, the third bullet there - "To avoid artificial or uneconomic
27 competition". I am assuming that reflects the concern you had earlier expressed about
28 promoting competition to engage in inefficient switching of installed meters. What is
29 'artificial or uneconomic competition'? A. Well, one of the problems with National
30 Grid's prices being set on a historic basis at above market level means that you could
31 actually get CMOs coming in whose costs on an ongoing basis weren't actually any higher
32 than -- weren't actually any lower than National Grid's. So, there are concerns about
33 whether or not what you are getting is efficient entry. I am not sure whether that is referred
34 to there, but, I mean, that is the kind of thing that I could have meant by 'artificial'.

1 Q Just to be clear, in your mind can there be such a thing as artificial or excessive, or
2 uneconomic competition or is all competition good? (After a pause): So, you would
3 want to maximise the amount of it in the market.

4 THE CHAIRMAN: Let her answer the question? A. I think you can have - whether it is
5 artificial - uneconomic competition, or competition where you have got players who are
6 coming in and are only able to compete because there is some artifice of the regulatory
7 environment that means it looks like there's an opportunity there where actually there is not.
8 I didn't think that was a big issue in this case.

9 MR. TURNER: In the second bullet, Ofgem is recording its aim to 'secure early customer
10 benefits in an environment where change could otherwise take some time'. Early customer
11 benefits were achieved by the price reductions offered by National Grid in the Legacy
12 MSAs and as part of its proposal, were they not? A. They were in terms of an immediate
13 price cut, but whether actually it was a price cut that justified the transfer of risks, where
14 customers could end up ultimately having to pay more downstream if meters are
15 subsequently having to be changed out -- There is a transfer of risk associated with the
16 reduction in price.

17 Q Can you explain exactly what you mean by 'transfer of risk'? (After a pause): Is it the
18 same risk which is moving from one party to another? Or, are we talking about two
19 different things? Just to be clear what you mean by that phrase -- (After a pause): We
20 have Transco's risk that people are going to be removing these assets prematurely. A.
21 If you take smart metering coming along under the P&M contracts, if all meters were
22 replaced as a result of some legislative changes, as perhaps is now on the books, National
23 Grid would end up taking the hit for that and would face the stranding risk. Once you've
24 got the MSAs in place with government introducing legislation to require a different form
25 of meter, it is now the suppliers, and hence customers, who are facing that risk because the
26 suppliers would be paying the PRCs. So, associated with the introduction of the PRC, you
27 get a reduced rental, which is a clear customer benefit, we accept. But, there is a price to
28 pay for that, which is that as a part of that reduction in the price, the suppliers are now
29 taking on a commitment to carry on paying that which otherwise they did not have. That is
30 what we mean by transfer of risk.

31 Q That is very helpful. If we turn to your e-mail at MF26 on p.1233 we can look forward.
32 Here we have a brief discussion of the briefing note. You are discussing this briefing note
33 with Callum McCarthy, Eileen Marshall, and John Neilson. Can you explain briefly their
34 positions? A. It may be that there is another MD involved as well. I can't remember

1 whether Richard Ramsay would have been in that meeting. But, they are the management
2 committee. Callum, is, as I've said, the chief executive. Eileen Marshall was the MD
3 responsible for trading arrangements and was Ofgem's chief economist. John Neilson was
4 the MD responsible for customers and supply. As I say, I think there was another MD
5 responsible for networks at the time. So, they constituted the management committee - the
6 MDs plus Callum. We were discussing this in order to make sure that they were
7 comfortable with the line that Callum would put to National Grid.

8 Q So, we see from the first paragraph that neither Callum, nor Eileen are sympathetic. Then
9 they refer to this point about Transco having already got a good deal out of the price control
10 review. "So, why should we do anything?" You talked about that. Then we have, "The
11 reasons we gave for looking at it --" The 'we' being --? A. John and I.

12 Q "-- were: the potential for an immediate customer gain [John], the need to avoid customer
13 disruption and economically inefficient replacement" over time.

14 THE CHAIRMAN: It does not say 'over time', but ----

15 MR. TURNER: "-- economical inefficient replacement [me]".. Two concepts that should never
16 be confused. Now, John is referring to the potential for an immediate customer gain and
17 that is a reference to the sort of across-the-board price reduction being proposed by National
18 Grid on the rental charges for its Legacy stock. A. Yes.

19 Q That is what he is talking about. A. Yes.

20 Q Then you refer to 'economically inefficient replacement'. Then you elaborate on what you
21 mean by that in a reported exchange with Eileen Marshall. If we pick it up half-way down
22 that big paragraph, beginning, "She didn't accept that premature replacement was
23 inefficient and said it was efficient if the replacement meters were cheaper. I said it wasn't
24 efficient, given that the in situ meters were a sunk cost. She said we'd never taken account
25 of this sort of argument in looking at generation. Of these points I have a lot of sympathy
26 with the first two and none at all with the last one which I'd say explains the current
27 problems in the generation market".

28 So, you were recognising at that time, Mrs. Frerk, that with a sunk costs business like this
29 one it is not efficient to replace the installed asset if you come across a slightly cheaper one.

30 A. That was my interpretation at the time, yes. Eileen Marshall obviously had a very
31 different view and has expressed her opinions clearly and been accepted by the CAT - in the
32 *Albion* case, I believe, talking about the differences between dynamic and static efficiency,
33 which is beyond anything that I am competent to talk about. But, just to set out in terms of
34 our relative positions, I think Eileen is a greater authority on these issues than I am.

1 Q Focusing on what you said there, what was the thinking underlying what you said? A. I
2 still feel that there is a sense in which it is inefficient to throw away a meter that is working
3 perfectly well because at the time it cost £100 and that money is sunk, and somebody has
4 got an identical meter that now costs £50 to produce. It does not seem to me a sensible
5 outcome - that you simply throw away the £100 meter and put in the £50 meter, in any very
6 lay sense. But, what Eileen was arguing was that that could still be efficient in the short
7 term if it gave the right signals to National Grid that they then needed to cut their prices.
8 You know, that is part of the dynamics of competition - that sometimes there is waste along
9 the way.

10 Q Madam, this may be a convenient moment. I apologise. I do have a little bit more, but I am
11 most of the way through now. I only have a little bit further to go. I cannot guarantee
12 precisely how long it will take, but I expect around half an hour.

13 THE CHAIRMAN: Then there will be how much re-examination, do you think?

14 MISS CARSS-FRISK: At the moment I would think very little, if any at all.

15 THE CHAIRMAN: Thank you. We will resume at two o'clock.

16 (Adjourned for a short time)

17 MR. TURNER: Mrs. Frerk, we were just leaving the note of the meeting in October 2002, and I
18 believe that the outcome was that you succeeded in persuading your colleagues to say that
19 Ofgem would keep looking at National Grid's proposal? A. Yes, we would keep talking
20 to them about that with an expectation maybe that the proposal would evolve in time, but
21 that we would keep talking, yes.

22 Q So the next letter from National Grid came through on 26th November, and I would like to
23 see what you say about that in your statement first at para.51, p.988. Could you read that to
24 yourself. You are summarising the elements of National Grid's proposal at that stage, and
25 you say in the third full line up from the bottom:

26 "... that of the proposed rental reduction ..."

27 which National Grid were talking to you about –

28 "... £1.60 of it was down to business rates and 50p was a pure reduction ..."

29 Yes? A. Yes.

30 Q What you do not mention in your statement, perhaps understandably, is the amount of the
31 final reduction included in the Legacy MSAs, but I am assuming that you are aware that it
32 was significantly larger than the amount stated there. Are you aware of that? A. I'm
33 aware it was larger, I don't have it off the top of my head what the amount was.

1 Q Absolutely. Could you take up the cross-examination bundle and look at tab 13, please.
2 Briefly what we have here is a table which very simply is comparing against the rental
3 charge tariff cap for credit meters, DCMs, for each of the financial years you see, the MSA
4 rental charges for Legacy 1 DCMs in the first column. The business rates effect comes in at
5 April 2005 – that is 2005/06 therefore – where you see the drop down to £12.74. What you
6 can see if you look at the right hand column is the levels of the actual or pure savings for
7 each year from 2003/04 to 2006/07. I fully understand that you are not aware of the details
8 of the figures. All I am asking you to note at the moment is the levels of these as what we
9 say are the final reductions, and to ask whether this fits with what you would expect to see?
10 A. As I say, certainly my understanding was that they were greater than the amounts we'd
11 been talking about, and these are greater, yes.

12 Q Let us move on. National Grid's letter of 16th December 2002. What happens is that on
13 16th December National Grid sends you a further letter in advance of a meeting with you on
14 that date, and that is MF30, tab 30, on p.1263. This is a letter addressed to David Howden,
15 the deputy head of metering from Mr. Tim Tutton, who is the UK director of regulation at
16 National Grid at that time. It is ccd to Mr. John Neilson and to yourself. On the first page
17 under "Discussions with Shippers", National Grid sets out the outcome of discussions of its
18 proposal with several key shippers to determine the level of interest. It says:

19 "During these discussions, Transco has sought to determine the level of price
20 reduction that would incentivise shippers to commit to a longer rental period. The
21 key points that have arisen from these discussions are:

- 22 ● in general, shippers agree that premature replacement of meters would be
- 23 inefficient and would not be in the best interests of consumers;
- 24 ● most shippers believe that our proposal is an appropriate response to
- 25 competition and, in particular, to the problems associated with stranding; and
- 26 ● all shippers see benefits in our proposal. Section 1.2 below sets out the
- 27 alternative pricing structures that have emerged from discussions with shippers."

28 I want to look at those alternatives, but just before doing so you will see the next sentence:

29 "In addition, shippers do not seem to be unduly concerned about the effect of our
30 proposal on the development of new technology."

31 If we turn over the page we have at 1.2.1 and 1.2.2 these two alternative structures. The
32 first of those, 1.2.1, relates to meters being rented until end of useful life. If you cast your
33 eye over that you will see that that was the basis of the initial proposal:

1 “Shippers would pay a premature replacement charge if they replaced the meter
2 before the end of its useful life. Shippers have indicated that they would be
3 content to pay such a charge, their main concern being that the charges must be
4 transparent so that they can easily work out the cost of replacing their portfolio
5 under various scenarios.”

6 So that is the option which, until this time, you had been debating in inchoate form with
7 National Grid – is that right? A. Yes, although I think the charges that you had in the
8 schedule that was sent to us in August ended at 20 years rather than at useful life, but I
9 accept it’s the basis of that debate.

10 Q Because there is a difference between those concepts? A. Yes.

11 Q Then “Fixed terms”, 1.2.2, we now have this alternative which comes in:

12 “Shippers that have given, or expect to give, volume commitments to their MOs
13 [meter operators] favour a slightly different approach. They would commit to
14 replacing Transco’s meters over fixed terms – for example, 18 years for credit
15 meters and 7 years for prepayment meters. Transco would agree with shippers
16 how many meters they could replace each year (consistent with the contract term)
17 and a tolerance band would provide a degree of operational flexibility. If shippers
18 choose to replace meters faster than the contracted rate (i.e. outside the tolerance
19 band), they could do so by effectively buying the meters, i.e. by paying the
20 premature replacement charge.”

21 This relates essentially, Mrs. Frerk, to the structure that we now find in the Legacy MSAs,
22 does it not? A. Yes, broadly.

23 Q We have got the 18 year period for credit meters and seven years for the PPMs, National
24 Grid agreeing with gas suppliers how many meters they could replace each year, the glide
25 path, the tolerance band and the payment of the premature replacement charges. Under
26 “Flexibility”, point 2 at the bottom of the page, you see that Transco also refer to being
27 careful to build flexibility into the proposal allowing accelerated replacement programmes
28 if suppliers wish. Then over the page, we see the bullets that were then under consideration,
29 including the tolerance band, including the effective buying of meters at the same level as
30 the premature replacement charge – yes? A. Yes, at that stage the assumption was the
31 meters would still transfer to the suppliers.

32 Q They say here, “effectively buying the meters”, i.e. by paying the premature replacement
33 charge. Without quibbling on the terms, they are talking about payment of the premature

1 replacement charge? A. I think there was one difference. That was one of the other
2 things that changed subsequently, but yes.

3 Q So you then meet with National Grid on the same day as this letter is dated to discuss this
4 proposal, and if we turn to MF33, we have a letter of 6th January from National Grid
5 beginning at p.1290. Do you have that? A. Yes.

6 Q This is thanking you for the meeting on 16th December and appreciating the opportunity to
7 update you. If you turn to the second page, 1291, at the top:

8 “As regards implementation, Transco stated that it intended to introduce the new
9 arrangements alongside, and as an alternative to, the existing metering terms and
10 conditions (which will remain in the Network Code until such time as they are
11 transferred to the new metering contract).”

12 So there we see, Mrs. Frerk, the National Grid making clear to you at the meeting that
13 bilateral agreements were the way in which they intended now to implement the proposal,
14 subject to Ofgem’s views on process.

15 If we then look at the next paragraph above “Imperial meters”:

16 “Ofgem stated they might wish to consult the industry in relation to the issues
17 raised by the proposals. Transco confirmed that it would welcome further details
18 on Ofgem’s views on process.”

19 The following two paragraphs are concerned with issues that were being debated about the
20 legality of sale of existing meters. For example, you will see this point under “Imperial
21 meters” where the question was whether it would be lawful to continue to use them if they
22 were sold? A. Yes.

23 Q That was one of the legal issues that was proving to exercise the minds of Ofgem and
24 National Grid at the time. We then jog forward and I am going to take this a bit more
25 quickly to Ofgem’s memo of 5th February ----

26 THE CHAIRMAN: Can you remind me, Mr. Turner, where we were with the Letter of Intent by
27 this stage, between National Grid and British Gas?

28 MR. TURNER: The Letter of Intent was December 2002 – the end of November 2002 – and so
29 by that time we have in principle heads of terms agreed with British Gas, not yet contractual
30 obligations, but they have crystallised the main aspects of the proposed contract. So madam
31 chairman, you are right, this letter follows on from those discussions having been held, and
32 in my submission it does so naturally. We then go to the memo of 5th February, which is
33 the Ofgem Management Committee briefing paper, which is MF34 beginning on 1296. It is

1 addressed from Mr. David Howdon, copied to yourself and Mr. Mark Allen, to the Ofgem
2 Management Committee. Do you have that? A. Yes.

3 Q Did you see this note before it was finalised, do you remember? Did you contribute to it?

4 A. I can't remember but I am almost sure that I would have done if it was a paper going to
5 the Management Committee, I would have seen it.

6 Q I will take you very briefly to certain aspects, para. 2:

7 "In May 2002 Ofgem identified concerns about the removal of meters before the
8 end of their useful life (referred to hereafter as premature replacement) on the
9 grounds that it was economically inefficient and led to unnecessary disruption to
10 customers. In response to that document Transco proposed to address premature
11 replacement by introducing premature replacement charges."

12 That is a fair, neat summary of the position, Mrs. Frerk, is it not? A. I think it is. If I was
13 writing it now I would put a "could" into "on the grounds ----"

14 Q Where would you insert a "could"? A. Okay, no, that's fine.

15 Q Paragraph 8:

16 "Transco's proposal is helpful in addressing the potential concerns raised in our
17 metering strategy update in relation to premature replacement. However,
18 premature replacement charges may constitute an impediment to the development
19 of competition and advanced gas metering since it will lock in the currently
20 installed technology and pricing structure (albeit at lower prices)."

21 Yes? A. Yes.

22 Q Mrs. Frerk, this is not different in effect such a situation from normal commercial
23 application of PRCs. Would there be a difference if commercial meter operators had also
24 locked in gas suppliers with PRCs, and then subsequently new technology had come along –
25 albeit at lower prices? A. I think the one difference is that without those contracts the
26 new CMOs would not necessarily have invested, because they would not have had the
27 confidence that they would recover their assets, whereas with National Grid those assets
28 were already there. So in terms of the customer getting a benefit, the customer gets a
29 benefit in that it gets investment that it might not otherwise have got in the case of a new
30 competitor coming into the market, but those meters are already there in the case of
31 National Grid.

32 Q Can I focus just on the effect of the gas supplier, on the customer – the effect is the same on
33 the customer because the application of charges arises in both cases? A. The application
34 charges arises in both cases, yes.

1 Q Paragraph 9:
2 “Informal discussions with suppliers suggest that they welcome Transco’s
3 proposals as bringing down prices in response to competition while still allowing
4 them the flexibility to install meters provided on a competitive basis at broadly the
5 rate they would have done anyway.”
6 Do you see that? A. Yes.
7 Q Can you clarify the extent to which that did reflect discussions that had been held by you or
8 your colleagues with gas suppliers in the market? A. My answer is I do not recall what
9 discussions we had. I would be surprised if this was written without us having had any
10 direct conversations. We could have just been repeating what National Grid said. Suppliers
11 were under a confidentiality agreement with National Grid, so they were not generally
12 discussing very much with us, the development of these contracts.
13 THE CHAIRMAN: They were under that agreement by February 2003? A. My answer is I
14 cannot remember what discussions took place.
15 MR. TURNER: Well, let us move on. Paragraph 11:
16 “Informal discussions with meter manufacturers suggest they also have concerns
17 about premature replacement arguing that it could lead to a situation of ‘feast then
18 famine’ in meter manufacturing. Hence manufacturers could be expected not to
19 oppose the proposals.”
20 Pausing there, would it be fair to say that meter manufacturers are concerned about feast
21 and then famine if there is premature replacement of meters? A. They are if the –
22 discussions were not had particularly in the context of the MSAs, but just generally – they
23 were concerned if you had five years in which all of the industry meters are replaced, and
24 then no further work for 15 years. That is what they meant by “feast and famine”, clearly
25 there are degrees of premature replacement that would or would not give them difficulties in
26 terms of their not having a steady flow of work.
27 Q So I think we can clarify that famine arises because newly installed meters have been put in
28 on an accelerated timescale which are then locked in by normal commercial arrangements?
29 A. Yes, how much it is an issue for the meter manufacturers is going to depend a lot on the
30 pace of replacement.
31 Q Paragraph 15, we have read now before in the Tribunal, so just cast your eye over that,
32 please. Essentially, what we have is Mr. Howdon, the senior economist on your team, who
33 is referring to the availability of the regulatory terms as weakening the ability of Transco to
34 abuse market power. Mrs. Frerk, this is a competition assessment rather than a regulatory

1 assessment. There is no licence condition that he is referring to here? A. I think what
2 this is saying is could we expect suppliers and shippers to get to a position that was a
3 sensible outcome for customers, and the fact that the P&M contracts were there gave them
4 an additional lever in discussing those issues with National Grid.

5 Q And when he refers to “weakening the ability to abuse market power” that is a competition
6 assessment rather than some regulatory assessment, measured by some licence condition or
7 other? A. Mr. Howdon had no competition law training or background. He may have
8 used that language but I would not have said he was actually attempting to make an
9 assessment under competition law. He wouldn’t have viewed that as his area of expertise,
10 he would have viewed it more generally.

11 Q Paragraph 16: the recommendation is that Ofgem neither endorses nor opposes the proposal,
12 but steps back, as it were - yes? A. Yes.

13 Q And what is said in the penultimate sentence is:
14 “This will allow Transco to pursue contracts with shippers and to find a market solution to
15 the problems which Ofgem had identified. We will continue to monitor the situation to
16 ensure that the best interests of customers are served”.

17 Mrs. Frerk, National Grid did pursue contracts and find a market solution to the problems
18 which Ofgem had identified, did it not? A. It did.

19 Q Discussions with gas suppliers. If we go back to your statement at paras. 77 to 89 - the last
20 part of your statement - you deal with a different topic, your discussion with gas suppliers.
21 Do you have that? A. Yes.

22 Q At para. 77 you deal with the question of whether two gas suppliers - SSE and Powergen -
23 contacted you to take your views on whether the MSA agreements were restrictive of
24 competition. Then, at para. 78 through to the end of that section you are dealing with a
25 different question, whether Ofgem had discussions with British Gas in which it expressed
26 concerns about accelerated replacement of meters, installed working meters. A. Yes.

27 Q I would like to start with British Gas and what you say in para. 79. Now, in this section,
28 and throughout this section you move quickly from referring to your personal position to
29 talking about what ‘we said and did’. So, we see that, for example, in para. 80: “We did
30 have a separate concern --“ ; at para. 83 when you say, “We would not have had any
31 concerns about an accelerated replacement programme that replaced meters at faster than
32 the natural rate on an ongoing basis”; and at para. 84, “We would have asked British Gas
33 about its plans, and so on”. My first question is: Who are the ‘we’ for whom you are

1 speaking in your statement here? A. I think there may be an element of the royal 'we'
2 there in that I am using 'I' and 'we' interchangeably.

3 Q Were you including your colleague, Mr. Baldock? A. Mr. Baldock would've had many
4 more discussions at an operational level because he was involved with the RGMA
5 discussions with BGT. So, he would've met them on a much more regular basis, but to
6 discuss very different issues.

7 Q Yes. Now, we have seen at para. 83 the statement I have just read - that you would not have
8 had any concerns about an accelerated replacement programme that replaced meters at
9 faster than the natural rate. Also at para. 87 where you are referring to British Gas' apparent
10 position reflected on the previous page. You say in your final sentence,

11 "I don't believe that we conveyed directly to British Gas any regulatory opposition
12 to an accelerated programme of replacing National Grid's installed meters as
13 National Grid claims in its notice of appeal".

14 Is that still your evidence? A. It's still my evidence in terms of what I believe, subject to
15 the caveat at para. 88 about the very short-term issues ahead of RGMA roll-out happening.

16 Q You have been in court and you have heard some of the documents being debated. But, that
17 remains your view about what Ofgem or you specifically said and did. A. Yes.

18 Q In para. 88, which you have just gone to, you refer there to the fact that you would have
19 had, or there would have been, absolutely no objection in Ofgem to a plan by British Gas to
20 replace National Grid meters before the end of their twenty-year life if in doing so British
21 Gas believed it could achieve savings or other benefits for customers. Pausing there, I think
22 you have been aware, and had been aware since August 2002 at least, that National Grid's
23 meters do not have a twenty year life, such as, for example, the definite certified life of
24 electricity meters. Yes? A. Yes.

25 Q You knew, at least from August 2002 that the replacement policy of Transco/National Grid
26 for gas meters was based on accuracy. A. Financial life. They were being depreciated
27 over twenty years.

28 Q I see. Now, your view at the end of para. 89 is that in the context of a competitive metering
29 market the whole idea was that suppliers should be determining how consumers interests
30 were best served. That is your position. A. Yes.

31 Q To clarify then, if British Gas had believed that it could achieve major cost savings for itself
32 by premature replacement of working assets with similar working assets, would that have
33 been a concern for you, or not? A. I think I could've envisaged having concerns in two
34 areas: (1) if these replacements were happening ahead of RGMA cut-over -- so, that would

1 mean that there was a risk that if an end customer switched supplier away from British Gas
2 - to Npower or somebody else - that that other supplier would not know who owned the
3 meter -- whether it was National Grid or a competitive meter operator. There was a risk that
4 billing and everything else would go awry. So, we were very concerned that there should
5 not be a massive change-out of meters ahead of RGMA cut-over. People believe they could
6 operate with manual work-arounds for a period, but not if volumes were too high. So, that
7 was the first area in which we might have expressed some concerns about anything other
8 than BGT saying they could make money.

9 I think the other way is that, you know, if they were talking about taking out meters over a
10 very short period, we would just want to make sure that there were no other reasons because
11 it would seem somewhat counter-intuitive to the way we would expect the market to work,
12 to make sure that there were not other issues that we had not thought about that might be
13 making the market artificial in some way and leading to somewhat unexpected behaviours.
14 So, we would have asked questions in that circumstance, but we wouldn't have signalled
15 opposition, as it were.

16 Q So, you would have been concerned about usable assets just being taken out and left in
17 various skips, for example. A. We would've been concerned about how that would've
18 looked to the outside world, yes.

19 Q How it would have looked to the outside world, was the concern? A. (After a pause):
20 I think that's the concern that drives us to do something other than rely on British Gas to
21 look after the customer's interests.

22 Q Can we turn to your cross-examination bundle at Tab 6? (After a pause): This is a letter
23 from September of last year in which Ofgem sent us, at our request, a copy of an e-mail for
24 Mr. Mark Baldock, who had left Ofgem, but which he had given to Ofgem the previous
25 year. A. Where are we again?

26 Q Tab 6 of the cross-examination bundle marked 'Frerk 1'. This is a letter, dated 2nd
27 September, 2008. At the bottom of the page it says 880. If you turn to p.882 you have this
28 e-mail from Mr. Baldock which had been sent to the Ofgem team, asking him questions
29 about his discussions with British Gas. This was disclosed to us in September last year Had
30 you seen this e-mail before? A. No.

31 Q Have you seen it before now? A. No.

32 Q On the second page, p.883 -- You will be able to read this for yourself, but I want to take
33 you, for reasons of time, to the second bullet point?

1 THE CHAIRMAN: Can I just check whether you have the whole of the document, including
2 some confidential ----? A. Some bits that are yellow.

3 Q You do. You have those bits. A. Yes.

4 MR. TURNER: In fact, madam, I do not. I am simply working from the e-mail from Mr. Baldock
5 which begins on p.882, half-way down the page. A. Sorry. I don't have anything above
6 that, but -----

7 Q Nor do I. A. -- I have everything on the second page.

8 Q On the second page, if we look at the second bullet point ----

9 THE CHAIRMAN: That is marked 'Confidential' in the copy that I have - the second bullet that
10 starts, "That, said I --"

11 MR. TURNER: I do not know who will have claimed confidentiality for that.

12 THE CHAIRMAN: Well, someone has gone to the trouble of covering it in yellow highlighter
13 pen.

14 MR. TURNER: Right. In that case, I am going to deal with it by asking you to read it to
15 yourself. Actually you may as well read down to the end, to save time. A. (After a
16 pause) Yes.

17 Q I have only two questions here. On that second bullet, the last sentence, my question is this:
18 when British Gas told you what they were going to do, did you welcome their approach
19 privately, or did you tell British Gas that you welcomed it? You may not recall. A. I
20 don't recall, no.

21 Q In the following bullet but one, beginning "I asked BGT to make their position public", did
22 you know that your colleague directly asked British Gas to make their position on this
23 matter public? A. I have a recollection, now I see it written there again – this is, he says,
24 May 2003 – I recall that now I see it there.

25 Q In 2002 or 2003, but you recall it? A. Yes.

26 Q On that note, if you turn in the same cross-examination bundle to the previous tab, tab 5,
27 and go to p.779 – I do not know if this is marked as "Confidential", it is not in my copy.

28 THE CHAIRMAN: Only the mobile phone number.

29 MR. TURNER: We have an email from you of 7th November 2002 to your colleagues, Mark
30 Baldock and Iain Osborne – do you see that? A. Yes.

31 Q Have you seen this recently, this email from yourself? A. This was shown to me by
32 counsel yesterday, because I think it appeared in the miscellaneous bundle, but I hadn't seen
33 it prior to that.

34 Q We start with Iain Osborne's email at the bottom:

1 “Annett and I met Lesley Davies the other day. Lesley told us she understands
2 BGT and UU have undertaken a programme of swapping out meters. I was a bit
3 surprised at this, and said we’d get back to here.”

4 Are you aware of this? Who was Lesley Davies? A. Lesley Davies was at Energy
5 Watch, which is the consumer body responsible for the energy sector.

6 Q What interest would you have in getting back to her about a programme of swapping out
7 meters? A. Energy Watch were a very vociferous consumer body and if they felt that
8 consumers’ interests were not being served by something that was happening in this area
9 they would have raised issues and concerns to understand what was happening in the
10 industry.

11 Q What would your role be in this process as Ofgem? A. Well, we dialogue regularly with
12 Energy Watch. They were the consumer body and we were the regulator.

13 Q On the other side you were also dialoguing with British Gas? A. With British Gas, yes.

14 Q We see above that now your email, which we can look at, and look at the second sentence:
15 “British Gas have said clear to us that initially they will only be changing out
16 meters when they come to the end of their lives or other meter work is required –
17 which all seems sensible.”

18 Do you see that? A. Yes.

19 Q Is it your position that you did not convey to British Gas that you thought this was sensible?
20 A. I think I said previously that I couldn’t remember what we would have said to British
21 Gas. Clearly the fact that they weren’t going rapidly ahead of RGMA is something that we
22 would have welcomed, and I imagine it’s quite possible that we would have made that clear
23 to them.

24 Q You went on:

25 “There remains a question as to the extent to which they might ramp up longer
26 term (but equally Transco might change their stance to make that unnecessary).”

27 So you envisaged that the threat of replacement from gas suppliers and CMOs could be
28 expected to lead to National Grid dropping its prices? A. Yes.

29 Q In which case premature replacement would be avoided? A. Yes.

30 Q Which is what happened with the Legacy MSAs? A. Well, a mixture of lower prices and
31 a premature replacement charge.

32 Q Can we, finally on this topic, look at ----

1 THE CHAIRMAN: Can I just ask you a question. Do I gather from this email that you were
2 aware at the end of 2002 of the British Gas tender? That is the ITT that we have been
3 talking about that happened at the end of 2001 – is that right? A. Yes.

4 Q You were aware of the case of replacement on which that tender was predicated? A. We
5 weren't aware of a lot of the details, but again we met regularly with British Gas's – both
6 Neil Avery and their regulatory lead, David Thorne, for them just to update us at a broad
7 level about where they were with their tenders and their replacement programme. We
8 didn't scrutinise the ITT or look at absolute numbers, but a broad sense of the pace of roll
9 out, as to when they were likely to actually start when they'd awarded the tenders, and so
10 on.

11 Q On that note, to update them broadly, as you say, could you be supplied with bundle M1 and
12 look at tab 21. My copy is covered in yellow, so I shall not read anything out. If you go to
13 p.121 in tab 21 ---- A. Mine is completely blacked out.

14 Q Is it.

15 THE CHAIRMAN: I think in the past the referendaire has supplied that.

16 MR. TURNER: This is a reference to British Gas broadly updating you about their intentions. If
17 you look at the top of p.121 now, the first bullet above the heading "Meter Operator
18 Volume Bands", can you please read the last sentence, "It is understood that". Does the
19 reference to the need to manage your expectations jog your memory about Ofgem's
20 dealings with British Gas on acceptable age threat, the replacement of installed meters?
21 A. I have no recollection at all of discussing specific age thresholds for meters, and I have
22 no reason to change my mind based on that.

23 Q I have almost finished now. Can you turn back to Powergen, para.77 of your statement and
24 cast your eye over what you say about your discussions with Powergen. You say in the
25 second sentence that you have some recollection of speaking to both SSE and Powergen.
26 However, the nature of the discussions is reflected in the Powergen note which you exhibit,
27 "... was simply to confirm that we were aware of the proposals, that we had neither
28 approved nor rejected them, and that we had thus left open the option for us to revisit the
29 issue if we were to receive competition complaints in the future."

30 Is that a full and accurate reflection of your discussions with Powergen in your opinion?

31 A. Well I have put in there "some recollection" and this is one of the areas where my
32 memory is more flaky, but that is my recollection prompted by the note that I saw of the
33 Powergen conversation.

1 Q I will show you one document which may help. If you pick up the cross-examination
2 bundle again and go to tab 10. We have here one of the gas supplier board papers, and this
3 is a draft, as you see from the first page at the bottom right – 15th March 2004. Do you have
4 that? A. Yes.

5 Q Turn to the second page, with the “Summary” at the top and look at para. 1.3, it is referring
6 to the Legacy MSA, and the sentence which reads: “Ofgem have been very keen to ensure
7 that competitive metering does not result in perfectly good meter assets being changed by
8 newly appointed metering service providers. This agreement ensures a co-ordinated
9 approach is taken by the industry to achieve independence from Transco. That is what they
10 said. Now, let us see what that was based on. If you turn to the previous tab, tab 9. Do you
11 have something that is blank or the full text? A. I have the full text.

12 Q I have a yellow box around the part I am interested in, but if you could read what is in the
13 yellow box to yourself in the first three lines? A. (After a pause) Yes.

14 Q This email is attaching the paper, or “Revised paper attached following comments received
15 so far”, and this is dated 15th March 2004, but the email underneath that is dated 11th March
16 2004. You see what the author says, there is reference to the author having spoken to a Mr.
17 Graham Kirby and a certain consensus about the comments in the paper about Ofgem?
18 A. Yes.

19 THE CHAIRMAN: Well there is no point asking her to read it to herself if then you are going to
20 read it out, Mr. Turner.

21 MR. TURNER: Graham Kirby, is he the man to whom you spoke about these issues? A. Yes.

22 Q And after speaking to you he also spoke to your colleague, David Howdon? A. He did.

23 Q You see that in tab 11 ----

24 THE CHAIRMAN: Who is Graham Kirby? A. Graham Kirby is head of regulation at – which
25 ever it is – Powergen.

26 MR. TURNER: Will you turn to tab 11 of that bundle, a letter to Ofgem from Powergen, then
27 called “EON”, 3rd October 2005. If you look at 2397 and look at the second bullet from the
28 top on 2397, which I hope nobody has in a yellow box.

29 “Powergen tested this with Ofgem before they signed the contract, first
30 approaching Maxine Frerk and then speaking to David Howdon. The Powergen
31 representative’s (Graham Kirby) notes confirmed that the Transco proposal was a
32 response to concerns at premature replacement of meters. The notes report that
33 Ofgem’s interest was to ensure a ‘fair and equitable’ position between suppliers

1 but they had subsequently ‘stepped back’ as they did not want to create a contract
2 in case of a complaint.”

3 Now, Mrs. Frerk, it is entirely accepted that you did not say to Powergen that you had
4 approved these contracts and that you said that you had stepped back, but would you accept
5 that you did communicate to Powergen, based on what you have seen, your position on the
6 question of premature replacement? A. I think I would have confirmed that the proposal
7 would have been brought forward by Transco in response to the concerns that we had raised
8 in our May document about premature replacement.

9 Q Only two more areas. First, on the question ----

10 THE CHAIRMAN: The next bullet there is also perhaps important, indicating how Powergen
11 seem to have interpreted the stance of Ofgem as they understood it. Do you accept that
12 things may have been said by Ofgem that they could properly have interpreted in that way,
13 or do you think they were mistaken in interpreting what was said to them in that way?

14 A. Clearly they took some comfort from the fact that we were aware of the proposal, and I
15 guess there is a difference of view about whether they would have then expected us to take
16 any action if we saw major concerns with it.

17 THE CHAIRMAN: Yes. Mr. Turner?

18 MR. TURNER: Finally, I want to deal with the question of whether National Grid made Ofgem
19 aware of the key elements of the MSAs, namely the ones which are objected to. If I may, I
20 want to begin with National Grid’s written representations on this question, which position
21 is maintained because they are here in the bundle. If you to tab 3 in the cross-examination
22 bundle, and in that to p.203, you have paragraphs 35 and 36, and just to be clear:

23 “It is National Grid’s view that the Authority did give tacit approval to the core
24 principles of the MSAs. National Grid does not claim that this tacit approval of
25 the core principles equated to an approval of each and every term in the MSAs,
26 nor that National Grid had a legitimate expectation that there would be no future
27 enforcement action.”

28 Then para.36:

29 “National Grid’s Written Representations were directed at the specific question
30 whether discussions with the Authority had led National Grid to believe that
31 certain core principles of the proposals were (at least not obviously) regarded as
32 acceptable.”

33 The references to the ability to levy PRCs *per se* and the Glidepath, Just to put the
34 proposition to you without the need, I hope, to go back to documents, would you accept that

1 those core principles were put to you and discussed with you in your discussions with
2 National Grid or not? A. I think in my witness statement I may have said we were not
3 aware of those principles at all. Clearly the letter of 16th December sets out something that
4 you have shown is very similar to the glidepath and PRCs. I think it is fair to say we had no
5 discussion with National Grid about that alternative structure in the December meeting, so
6 although it was in the letter we did not discuss it with them, and therefore it was not in my
7 recollection as I was setting out the elements that we were not aware of in my witness
8 statement. I still maintain there are a number of other elements that had changed. Clearly
9 the contracts developed very significantly between the end of the discussions and their
10 introduction. But I can see now that the December letter contained within it something that
11 could be seen as a description of the glidepath, although I have not recognised that
12 previously in putting my witness statement.

13 Q Can we turn back to tab 34 in your bundle, attached to your witness statement, just to
14 remind ourselves how matters were left at the end of the February 2003 paper for the
15 Management Committee. The last sentence in para. 16 was that you would continue to
16 monitor the situation to ensure the best interests of customers were served. Did you do that?
17 A. I mean, we continued to talk, as we were doing, to members of industry. So, I suppose
18 we monitored the situation by being ready to pick up on any issues that were raised.

19 THE CHAIRMAN: When was the first time that you actually saw the Legacy MSA? A. It was
20 provided to David Howdon on my team for the purpose of checking that it met with the
21 regulations about publishing charges. But, as you know - I can't remember counsel's words
22 that he used, but - it was a horrid contract, or a horrid document. I mean, it's several
23 schedules. So, we didn't actually read all the way through it. We did have a copy of it for a
24 very specific regulatory purpose in October ----

25 MR. TURNER: Mrs. Frerk, I am afraid that is not entirely fair. Therefore I will pick you up on
26 that. Could you pick up Bundle SD2? Turn to Tab 84. I would just like to push back on the
27 impression that what was submitted to you was some horrid, impenetrable thicket of
28 legalities. Page 1402. September 2003. We have National Grid sending to Mr. David
29 Howdon a draft copy of the charging statement that Transco was currently producing in
30 respect of the proposed new term metering contracts. He explains in the cover e-mail what
31 those are doing. But, I would ask you to turn the page, to p.1403 and 1404. If you look at
32 the top of p.1404 it refers to,

33 "This publication sets out Transco's charges for meters provided in accordance
34 with the following contracts ----"

1 Then there is the Legacy one referred to, and then the new and replacement, both in capital
2 letters. Then if you look at the following paragraph you will see that there is a clear and
3 simple explanation, and an entirely accurate one, of what the Legacy contracts involve and
4 the new and replacement contract involves - that customers can choose to contract under
5 either or both of the contracts, or continue to take metering services under the network code
6 arrangements. Then, if you turn over the page, at 2.2, at the top, you have a description of
7 the glidepath; you have a description in the third sentence and following of the BLR band.
8 Then, over the page, at p.1406, under 2.4 - 'Premature Replacement Charges' you have a
9 description of the operation of the premature replacement charges. Finally, on p.5 of 6
10 (p.1407) you have a very clear and accurate explanation of the principles. You see that.
11 A. Yes.

12 Q You will see, if you look at the top of p.606 - and the Tribunal can read this to itself at
13 leisure later:

14 "Therefore there is a linkage between annual rental charges and premature
15 replacement charges [payment completion] and average value is shown in the
16 tables illustrative of the charge that would normally be expected to apply. If a
17 shipper's portfolio varies from the expected profile, then calculation of the charge
18 will be in accordance with the methodology and values specified in the relevant
19 contract".

20 So, it was not a question, Mrs. Frerk, of a 'horrid contract' filled with legalities being
21 thrown at you that was difficult to interpret. My suggestion is simply that Ofgem was
22 provided, albeit in this connection, with a clear and simple explanation of the contracts and
23 their operation. A. I accept that I was obviously over-stating it in terms of saying that we
24 had been provided with a copy of the contract, which is what I had understood. But, this is
25 a clear summary provided to us for the specific purposes of whether this complied as a
26 charging statement for National Grid to make sure its charges were transparent.

27 THE CHAIRMAN: This was sent to Mr. Howdon. But, do you remember also having sight of
28 this? A. I didn't look at that. I mean, it was provided to Mr. Howdon purely for the
29 purpose of checking it met with their license obligation to publish the information, and he
30 dealt with that. I didn't look at this document at all at the time.

31 MR. TURNER: There as no anxiety expressed by Ofgem about the structure of the PRCs in the
32 Legacy MSAs until April 2007 with the supplemental statement of objections. That is
33 correct, is it not? A. About the ----?

34 Q The structure of the PRCs. A. About the fact that they were not age-related?

1 Q Yes. A. Yes.

2 Q One final question, Mrs. Frerk: this Decision is competition law enforcement action by
3 Ofgem. Was it part of the thinking at Ofgem when you were taking this action that it would
4 help achieve wider regulatory objectives? (After a pause): I will be specific. At first, the
5 objective of maximising the extent of new entry in the market and of replacement activity.
6 A. No. I mean, insofar as we had a regulatory objective it was around ensuring that
7 competition was working and able to work properly and I understand that to be the aim of
8 competition law as well.

9 Q Nor the aim of nullifying the MSAs going forwards to minimise the costs for all gas
10 suppliers to introduce smart technology in accordance with government plans. A. No.

11 Q Thank you. I have no further questions, madam.

12 PROFESSOR STONEMAN: If we can go right back to the beginning of your evidence -- I think
13 Mr. Turner has shown that the price cap provisions in the P&M pricing really gave National
14 Grid very little relief for asset stranding when it came to the P&M for meters. A. Yes.

15 Q But, I think your evidence is that some allowance had been made on the transmission side
16 that would compensate for this. Is that your evidence? A. My evidence - which comes
17 back to this focused/unfocused - is that an unfocused approach was very helpful to them in
18 the transmission side, and applying that same principle on metering was unhelpful.
19 Therefore, it wasn't that they were explicitly compensated for the stranding costs by moving
20 the assets across to the transmission side, but that by applying one set of principles to both
21 bits of the business, they gained in one area and they lost in another.

22 Q Do you have any feel for how much they gained on the transmission side through this
23 unfocused approach that might be offset against their stranded asset costs? A. I don't. I
24 have a feeling the figures may be somewhere in our evidence. I'm sure counsel could find
25 them if they were. Transmission is by far the larger part of their business and overall, as
26 I've said, it was clear that they viewed the fact that we adopted that principle as beneficial
27 to the group.

28 Q Although we have both of the documents we have not come across that number. A.
29 Perhaps it's not there then.

30 Q I wonder, would counsel be willing to supply that number?

31 MISS CARSS-FRISK: Yes, certainly. A. If it exists.

32 THE CHAIRMAN: I have just a couple of questions: the extent to which you were relying on
33 BGT to arrive at a consumer friendly result in its negotiations with National Grid -- I think
34 Mr. Avery was clear in his written evidence that because National Grid was subject to a

1 non-discrimination provision which meant that they would have to offer price reductions to
2 everybody in the industry, that British Gas's interest was more in getting lower prices for
3 itself from the CMOs for which it got the sole benefit, as it were? A. Yes.

4 Q Which helped it in the retail competition. Was that something that you were aware of at the
5 time, or you did not really take that into consideration? A. No, it was not something that
6 we thought about at the time. They didn't push as hard with National Grid as they might
7 have done because those benefits would accrue to everybody. I'm not sure we would, if
8 National Grid had approached us, necessarily have taken that interpretation of a very strict
9 interpretation of undue discrimination that they took, i.e. there could be no differences, only
10 that they needed to be objectively justified.

11 Q In your witness statement at para.63, you say that once it became clear that National Grid
12 were going to seek to arrive an outcome through bilateral contracts rather than through
13 modification to the Network Code, from your perspective Ofgem's interest in the proposed
14 revised charges ceased. You have said that from your perspective, but was that generally
15 Ofgem's stance that it regarded the question of bilateral contracts which would then be
16 assessed against ordinary competition law as not something it should intervene in before the
17 contracts were concluded? A. That, I would say, was Ofgem's position and in some
18 senses what we were taking to the management committee in February, i.e. we weren't
19 going to endorse or oppose them, and just leave industry to get on with the commercial
20 negotiations. Clearly if we picked up issues, if we heard of issues or concerns, then we
21 would follow them up. We were much reactive after that.

22 Q You were not proactive ---- A. We weren't proactive.

23 Q -- once it had moved to what you considered to be *ex post* regulation rather than *ex ante*
24 regulation? A. Yes.

25 Q Thank you. Is there any re-examination?

26 MISS CARSS-FRISK: I have very little, madam.

27 Re-examined by Miss CARSS-FRISK

28 Q Mrs. Frerk, you might want to have p.1233 open in front of you, WS2, tab 26. You may
29 remember that just before lunch you were asked about that email, referring, as it were, to an
30 internal debate about premature replacement and inefficiency. You described that ----

31 THE CHAIRMAN: We are looking at two different pages, what page?

32 MISS CARSS-FRISK: Page 1233, tab 26. You referred to Eileen Marshall as the chief
33 economist at Ofgem at the time – that is right, is it not? A. Yes.

1 Q Can you describe her level of seniority compared to yours at the time? A. She was a
2 managing director, and I was a director, so I was a level below. I reported in to John
3 Neilson who would have been her equivalent. So Eileen was my superior.

4 Q Are you able to help us at all as to whether that particular internal debate referred to in that
5 email was subsequently resolved, and if so how? A. It was very clear, if National Grid
6 had proceeded to a code modification, that it would have to go back to management
7 committee to be approved or rejected. So I think the sense was I was having to take
8 management committee steer, i.e. to put a strong emphasis on the competition
9 considerations forward, in the discussions that I was having with National Grid.

10 Q If the matter had proceeded through a Network Code modification, can you tell us a little bit
11 about the process, what actually would have happened and the criteria applied?
12 A. National Grid would have put forward a code modification, and there is a process of
13 industry for working out the detail of that, for having an industry consultation on it, and
14 then a report is put to Ofgem effectively by the industry that says whether or not they
15 recommend that we approve the mod. We then have to take that final decision. We do that
16 against a set of criteria that are set out in the code, which include things like economic and
17 efficient – I am not sure of the details, but that kind of thing – together with our principal
18 objective, which is set out in statute to protect the interests of consumers wherever
19 appropriate by promoting effective competition. So that would have been a test that we
20 would have had to use in deciding on any code modification.

21 Q You were asked about Ofgem’s view that there needed to be a benefit to consumers out of
22 contractual arrangement that might be reached to deal with what Grid have described as
23 their stranding issue. Looking at the MSAs that resulted in the end, what is your view as to
24 whether they have had an overall benefit for consumers? A. I think that’s a difficult
25 question actually weighing up all the – there are advantages in terms of the reduced price,
26 but there are significant costs in terms of the longer term impacts through the promotion of
27 competition and hence the pressures on customers. Overall our conclusion is that the MSAs
28 did not provide a net benefit to customers.

29 Q Do you have information as to the extent to which the lowering of rentals in the MSAs have
30 been passed on to consumers by the gas suppliers? A. I don’t think one can ever answer
31 that kind of question, because there are so many different costs that go into the pot of what
32 counts towards customers’ bills. Our assessment of the market is that it is very largely
33 competitive, so ultimately we would believe that those savings should be passed on to
34 customers.

1 MISS CARSS-FRISK: Thank you, Mrs. Frerk.

2 THE CHAIRMAN: If the Network Code modification had happened, would that then have
3 replaced the P&M contracts? A. Originally the charges were within the Network Code,
4 and then what they did was sort of lift and shift those out into the P&M contract. So it
5 would have happened in two stages. It would have started off as a Network Code
6 modification and then ultimately that would have moved into the P&M.

7 THE CHAIRMAN: Thank you very much, you are released from the witness box.

8 (The witness withdraw)

9 THE CHAIRMAN: Why do we not take a short five minute break before we start. It is
10 Mr. Shuttleworth who is next, is it not?

11 MR. TURNER: Mr. Shuttleworth, madam, and Mr. Pickford will be taking that witness.

12 THE CHAIRMAN: We will resume then at 3.15.

13 (Short break)

14 MR. TURNER: Just before introducing the first expert witness, there is a point raised with us by
15 the referendaire, and it relates to the table of information that Professor Stoneman asked us
16 to produce, the equivalent annual rentals, if you take out the meter stock in a progressively
17 shorter number of years. Madam Chairman, you said that we could decide who would
18 speak to that. It will be Mr. David Matthew, who is one of the economists giving evidence.
19 The intention is that we will produce this table by tomorrow morning and he will then be
20 able to speak to it with Professor Stoneman. I wonder, Professor Stoneman, whether it
21 would be possible to clarify, to the extent you feel able, the issue that you wish to explore
22 based upon that table, so that Mr. Matthew can think about it, or whether that is
23 inappropriate?

24 PROFESSOR STONEMAN: No, it is fine by me. The main issue I wanted to get at was how
25 quickly the incentives change in terms of the overall rental, how quickly the incentives
26 changed the effective life of the stock. The one-seventeenth replacement policy, is that
27 really significantly different from the an eighteenth share replacement policy, or does it
28 drop down so that you do not get a significant difference until you get to about 12. So
29 really it is a matter of looking at the profile of rentals over different replacement strategies.

30 MR. TURNER: I am very grateful.

31 THE CHAIRMAN: Yes, Mr. Pickford.

32 MR. PICKFORD: Madam, thank you, I would like to call Mr. Shuttleworth.

33

34

1 Mr. GRAHAM SHUTTLEWORTH, Affirmed

2 Examined by Mr. PICKFORD

3 Q Mr. Shuttleworth, do you have in front of you a bundle with WS6 on its spine? A. Yes, I
4 do.

5 Q Can you go to tab 23, please, in that bundle? A. Yes.

6 Q Do you have there a report entitled: "First Expert Report of Graham Shuttleworth"? A. I
7 do, yes.

8 Q Is that your expert evidence in these proceedings? A. Yes.

9 Q If you could go through to p.29 of that report? A. Yes.

10 Q Is that your signature? A. It is, yes.

11 Q Is that your declaration above it? A. It is, yes.

12 Q Madam, with the permission of the Tribunal if I might just ask one or two very short
13 questions, in particular picking up on a point that Professor Stoneman asked about just
14 before the short adjournment.

15 THE CHAIRMAN: Yes.

16 MR. PICKFORD: Mr. Shuttleworth, would you go to para. 83, please, of your report?

17 A. Yes.

18 Q There you are responding to a point by Mr. Smith about the 1997 asset revaluation. Did
19 you deal there with the relevance of a focused versus unfocused approach in terms of its
20 implications for National Grid? A. For National Grid, are you distinguishing – this is
21 about the 1997 revaluation, the valuation for Transco, are you distinguishing between
22 Transco and Grid?

23 Q Sorry, for Transco generally? A. This just deals with valuation of Transco's assets and
24 the Grid assets, yes.

25 Q And did you there look at that in terms of its relevance for the particular implications for
26 Transco? A. No, I really just looked at the overall effect of one method rather than the
27 other.

28 Q Is that something that you can speak to, to assist the Tribunal? A. As a matter of
29 principles, yes.

30 Q And would you care briefly to do so? A. If I am invited to do so, yes.

31 THE CHAIRMAN: Mr. Pickford is inviting you! (Laughter) A. I was wondering if there was
32 a particular question from Professor Stoneman that I should address.

33 PROFESSOR STONEMAN: In para. 82 you quote:

1 “[t]he effect of applying the ‘unfocussed approach’ was to significantly increase
2 the overall regulatory value of Transco’s assets ...”

3 And what I was trying to get a feel for was what benefit did this yield to Transco in terms of
4 setting the possible stranding of its meter assets although it came via the valuation of the
5 transmission assets? A. I don’t think it had any implications for meter assets. The 1997
6 decision was essentially a breakdown of the asset value between transportation and storage
7 where metering was bundled with transportation, so it had no implications for the future
8 valuation of the metering assets.

9 Q Is 1997 the right date? A. It is.

10 Q It is just that the previous witness said to us that there was this stimulus to the transmission
11 assets – I thought it was 2002 and not 1997.

12 THE CHAIRMAN: I think the point that was being made was that it was presented by Mr. Smith
13 as if there had been a real choice between focused and unfocused in 2002, and that they had
14 chosen unfocused, and this gave certain benefits to National Grid. As I understood the
15 point you were making here is: they have always used unfocused so there was not really
16 such a shift going on, the idea of using the focused approach had never been canvassed –
17 certainly in 1997. Is that what you are saying? A. Yes, that is a reasonable summary,
18 yes.

19 MR. PICKFORD: I am sorry, madam, Mr. Shuttleworth may recall he does go on to deal with the
20 later situation in the following paragraph, para. 83, and the comparison that is made there.

21 PROFESSOR STONEMAN: The point made there is the point that Mr. Turner made earlier that
22 the MAR revaluation did not increase the overall regulatory value of Transco’s assets,
23 rather it led to 40 per cent discount. That is fine, but what we would like to know is without
24 the unfocused approach would the discount have been 60 per cent, or 70 per cent, or 80 per
25 cent? So was there, in fact, an advantage to Transco relative to the counterfactual that came
26 from using the unfocused rather than the focused approach? A. I am not sure the focused
27 approach was ever a realistic counterfactual. There was a lot of discussion about it, but in
28 successive decisions there was always a recognition, there was no real reason for adopting
29 it. It was more advocated than considered as a real possibility. That is why I conclude it
30 does not represent a useful or informative standard for measuring the RV.

31 THE CHAIRMAN: When you have a business of which now, as opposed to previously, one part
32 of the business is going to be deregulated and left open to competition and the rest of the
33 business is going to remain regulated, would you not expect that you would then try and
34 separate out the assets of the part of the business now going to be subject to competition

1 from the rest of the regulated assets so that might be why they would have contemplated
2 using the focused approach for the metering assets? A. I think we need to delve a little
3 into the detail. Let's distinguish between two different types of focusing. You are right
4 inasmuch as if one is separating out an asset to put it into the competitive arena one might
5 consider the value that should be placed on that asset. In the context of the separation of
6 metering for the electricity distribution companies their value was pre-set at the depreciated
7 replacement cost rather than some previous book value, in order to make them more robust
8 in the face of competition. That has been described as a form of focusing in some points.
9 But the focusing to which Mr. Smith is referring, and which was carried out in 1997 is not
10 that kind of focusing. There was no recognition of the market value of the assets in the
11 competitive arena or the depreciated replacement cost. What they are talking about there is
12 this distinction between using the book value of the assets or 60 per cent of the book value
13 of the assets. The relationship between those numbers and the competitive market value of
14 those assets was not in discussion. It was purely and simply an accounting mechanism, two
15 accounting valuations that were being discussed. The one accounting value attributed the
16 discount on an unfocused – in other words 'common' basis – the other one suggested the
17 adoption of accounting rules which somewhat arbitrarily really allocated a discount for
18 accounting reasons only, actually conversely with the conclusion that you would reach if
19 you were to look at market valuation. In other words they were driving up the value of
20 assets in a competitive arena.

21 THE CHAIRMAN: Yes, thank you, Mr. Shuttleworth.

22 MR. PICKFORD: I have no further questions. Please stay there, Mr. Shuttleworth, thank you.

23 Cross-examined by Miss CARSS-FRISK

24 Q Mr. Shuttleworth, still on para.83 of your report, I hope we might establish common ground
25 here, would you open a bundle CB1, and go to p.23, I want to take you to a paragraph of
26 Ofgem's Decision? A. Core bundle CB1 and which tab?

27 Q It is tab 1, p.23 and it is para.2.56? A. "Ofgem also considered any potential stranding
28 costs --" etc.

29 Q Yes.

30 "As part of the wider price control discussions, the significant issue had been
31 whether Ofgem would adopt a 'focused' or 'unfocused' approach to valuing
32 transportation and metering assets".

33 Then, the distinction is explained. There is a reference to the unfocused approach having
34 been taken by the MMC in 1993. In about the middle of the top paragraph on p.24,

1 “Ofgem decided to use an unfocused approach to valuing the assets of Grid’s
2 metering and transportation assets. This decision was of significant financial
3 benefit to Grid’s shareholders in the context of the settlement overall”.

4 Then there is reference to cost of capital. Then,

5 “In its annual report of that year, Grid commented that if Ofgem had taken a
6 focused approach it could have reduced Transco’s regulatory value by up to £2
7 billion”.

8 Mr. Shuttleworth, I do not know if you are familiar with that reference to the annual
9 accounts. Are you happy to take it from that note of it in the Decision that that is indeed
10 how Grid perceived it? A. Yes, I’m happy to take that as being that.

11 Q Yes. It may, however, be helpful for the Tribunal’s benefit just to have a look at the
12 accounts. One place you have them is SD1, Tab 11, p.705. If you look in the left-hand
13 column of p.705, under the heading ‘New Regulatory Contract’ you see it says, “The most
14 important aspect of the last fifteen months ended 31 March, 2002 was our acceptance, in
15 October, of Ofgem’s final proposals for Transco’s future price control. After careful
16 consideration, the board concluded that Ofgem’s overall package of proposals and related
17 assurances met our key criteria”.

18 Then the particularly relevant passage is just across in the right-hand column:

19 “Most importantly, acceptance of the final proposals leaves Transco’s regulatory
20 value intact, with Ofgem deciding against the use of the so-called ‘focused’
21 approach, which could have reduced Transco’s regulatory value by up to £2
22 billion . . . the new price control provides assurance on the value of transportation
23 assets on which Transco is entitled to earn a regulatory return”.

24 Now, I wonder, Mr. Shuttleworth, if, in the light of that notation in Grid’s accounts as well
25 as in the light of para. 2.56 of the Decision, you might be happy to accept that certainly so
26 far as Ofgem was concerned there was an issue to be debated as to whether to use a focused
27 or unfocused approach in relation to the 2002 price control? A. (After a pause):
28 Ofgem likes to debate a lot of things. The question is whether they were doing so as a
29 negotiating tactic, or just rattling sabres, or as a kind of second marriage policy of the
30 triumph of hope over experience and get another bite at this cherry. This decision had been
31 reviewed several times and dates back ten years. Ofgem might have wanted to re-open it. I
32 think, as I say in my report, that their chances of succeeding were minimal, given the
33 history, and that the outcome of the focused approach, while the amount is not in doubt, was
34 very unlikely, as I say in my report.

1 Q Just to provide all the relevant information we have - or, at least some further relevant
2 information on that - could the witness please be provided with -- I am afraid this is a
3 further document, but it is only one. (Same handed) What you have there, Mr.
4 Shuttleworth, are the relevant passages from a May 2000 consultation document headed
5 'Review of Transco's Price Control from 2002'. We can certainly copy at least the front
6 page for the Tribunal - and indeed the whole document if it would help so that it is very
7 clear what it is. The relevant passages, Mr. Shuttleworth, is on pp.53 at para. 6.20. A. I
8 am sorry. Can you repeat that reference?

9 Q Paragraph 6.20 at p.53. A. I have a para. 6.20 on p.52.

10 Q That is rather mysterious, but I hope the paragraph is the same that I have. Does it read,
11 "However, there are also three reasons ----? A. It does. But, it is listed as p.52 in my
12 copy.

13 Q I am sorry.

14 "However, there are also three reasons why it might be inappropriate to continue
15 to use an unfocused approach: Firstly, it is arguable that use of the unfocused
16 approach does not correctly establish the value of shareholders' investment in the
17 Transco business; secondly, Ofgas used an unfocused approach in 1996, partly
18 because of the lack of reliable information on the values of the other British Gas
19 businesses ----"

20 If you go to the last sentence of that paragraph,

21 "It is for consideration whether or not the information available on the values of
22 the different parts of the former British Gas has improved to such an extent that
23 the rationale for adopting an unfocused approach in 1996 may no longer apply.

24 Lastly, the focused approach has been used in setting other price controls ---"

25 Then you have reference to the MMC's approach in its report on Northern Ireland
26 Electricity and some other references.

27 Mr. Shuttleworth, perhaps in the light of those passages you might feel able to agree with
28 me even more clearly that it does appear that Ofgem saw it as a real issue for them as to
29 which approach they should adopt. A. I can't say whether they saw it as a real issue or
30 we are just rattling sabres to threaten National Grid with a fate worse than their current
31 situation. You are asking me about their intent. Paragraph 6.21, for example, which raises
32 the question of information available omits the reference to the fact that there should be
33 information available as at 1991. I know that Ofgem did investigate what information was
34 available about the value of assets as at that date. There is a report by Ernst & Young, which

1 is still available on the Ofgem website, that looks into that question by investigating what
2 was said in analysts' report at that time. So, yes, Ofgem did consider it worth investigating
3 at that time. But, the Ernst & Young report unequivocally concludes that there is no
4 information at all in those analysts' reports that would make it worthwhile reviewing that
5 decision. I think that's an entirely unsurprising result.

6 Q The question posed at the end of para. 6.21 is, of course, whether the information available
7 has improved. A. Yes, and that was the task given to Ernst & Young with a proviso that
8 they should, of course, be considering information available as at the end of 1991.

9 Q Mr. Shuttleworth, I think we can probably finish on the basis that certainly taking these
10 paragraphs at face value, they would suggest that Ofgem was considering this issue. A. I
11 don't think anyone working in regulatory matters ever takes Ofgem's statements at face
12 value, but you can do that if you wish.,

13 Q I might think that is unkind of you, Mr. Shuttleworth.

14 THE CHAIRMAN: This is an extract from a consultation document of the investigation that led
15 up to the 2002 price control.

16 MISS CARSS-FRISK: Yes. We will certainly copy the front page so that it is clear. Would it be
17 helpful to have the whole document?

18 THE CHAIRMAN: No. I think if we just have the front page, that will be fine.

19 MISS CARSS-FRISK: Yes. Mr. Shuttleworth, then just looking briefly at what you say about
20 Mr. Smith's statement, p.3415, where you comment on his para.40, and I would like you,
21 please, to focus on para.4.1.3 of your report. A. I have that in front of me.

22 Q And this is what you referred to as "Mr. Smith's paragraph 40, section 3", and just so we
23 know what we are talking about, he says:

24 "Even if no adjustments were made and the RAV reflected NG's historic metering
25 investment, this is not the same as the company's sunk costs as it would not take
26 account of the fact that some meters (particularly relatively valuable PPMs) could
27 be refurbished and reused."

28 Your comment, as I understand it, in para.75 of your report is, first of all, you acknowledge
29 that sunk costs represent the value of past investments adjusted for any commitments that
30 can be "reversed"? A. That's correct.

31 Q Then you say:

32 "However, I also note that the 'reversible' component is only the value – net of any
33 costs of removal, refurbishment and reinstallation – that the assets have when
34 reassigned to an alternative use or sold for scrap."

1 A. That's correct.

2 Q I think it is right then that if, in fact, Mr. Smith was referring to the possibility or reuse of
3 meters outside Grid's business, for example, by sale to the CMOs, then there would be no
4 disagreement between you? A. You must distinguish between mere transfer of
5 ownership and the process I am referring to here where the asset is removed, refurbished,
6 sold to someone and reinstalled. When discussing sunk costs, just changing the ownership
7 doesn't alter the nature of the costs. There are some extracts attached to my report referring
8 to factories and whether the cost of a machine is a fixed cost or a sunk cost in the extract
9 from the book by Mr. Tirole nothing would change in that analysis if, during the period in
10 question, the factory owner was to sell the factory. The status of the costs does not change
11 as a result. In terms of removing the asset, refurbishing it, reinstalling it and selling it to
12 someone else, that would be an alternative use. That would represent a reversal, if you like,
13 of the commitment, and I think it's in relation to that that the statements about the small size
14 of that net revenue are being made by National Grid.

15 Q So on the basis then that what Mr. Smith had in mind in his para.40 was precisely that in
16 relation to selling these assets to the CMOs, for example, I think where we are at is that
17 there is no disagreement between you? A. When you say "selling the assets to the
18 CMOs", do you mean after removing them, refurbishing them?

19 Q Yes. A. In that case, you're right, there is no disagreement. The question is purely about
20 the size of the net revenue that can be attracted from that source.

21 Q Thank you, Mr. Shuttleworth, those are all my questions.

22 THE CHAIRMAN: If you sold it for some money, even if you did not have to take out the meter
23 and refurbish it and reuse it, are you saying that the proceeds of sale would not have to be
24 taken into account? A. I don't think it would affect the definition of what constitutes a
25 "sunk cost".

26 Q So that would not be part of recouping in the sense that that word was used by somebody
27 that you quote? A. Mr. Tirole, Professor Tirole, yes.

28 PROFESSOR STONEMAN: Could I take that a little bit further, it would still be the same sunk
29 cost, but it would be in different ownership? A. That's correct, yes.

30 Q Do you think if the CMOs were carrying the sunk costs as opposed to National Grid
31 carrying the sunk costs, that the outcome on the market would be different? A. Sorry, if
32 they were carrying the sunk costs of the meters formerly owned by Grid?

33 Q The current position is that Grid will not sell their meters, they will only rent them out to
34 gas suppliers. A. I understand.

1 Q In that sense, these are really sunk costs for Grid, because with that policy they cannot sell
2 them, they can never recover the costs of these assets by selling them because they have
3 decided never to sell them. Let us say that they did sell them and they sold them to a CMO.
4 For that sale National Grid would get something, it may not be very much, but that would
5 be some reversal of their sunk costs, some recompense for their sunk costs, but now the
6 CMO will have paid for some assets that it has now got as a sunk cost. A. I find it easier
7 to think of that, sir, as a recompense of the sunk costs rather than a reversal. Yes, National
8 Grid could achieve some recompense for its sunk costs by selling them to someone else.
9 The price that the company buying the meter paid for that asset would then, I suppose,
10 become the sunk cost to that new owner.

11 Q Precisely, they would still be sunk costs, but they would be in different hands? A. And a
12 different amount probably.

13 Q Yes, all right. Would you expect the market outcome to be different? A. The market
14 outcome – can you explain to me what you mean by the “market outcome”?

15 Q Previously there were prices and quantities and distributions in the market, distribution of
16 the market share, between the different players. Now we have changed the situation, we
17 have changed the location of sunk costs, we have changed the location of assets. Would
18 you expect market shares, prices and other matters in the market to be different than they
19 were previously? A. The transfer of that one meter immediately affects market shares, at
20 least by one meter. So I presume your question is more addressed to the level of prices or
21 the level of replacement?

22 Q Let us say prices. I am thinking not in terms of one meter, I am thinking of a quarter of the
23 stock or something. A. I have not really been asked to look at the conditions of the
24 metering market, so I am only really able to answer from the point of view of long lived
25 assets, and I’m not sure that’s terribly helpful in these circumstances.

26 Q Really I was trying to get to the situation that sunk costs are sunk costs definitely, but the
27 ownership of sunk costs need not stay in the same hands – that is all I am trying to say.
28 A. I think I would agree with that point.

29 PROFESSOR STONEMAN: Thank you.

30 THE CHAIRMAN: Do either of the interveners have any questions you want to ask – no. Any
31 re-examination, Mr. Pickford?

32 MR. PICKFORD: Just one matter, madam.
33
34

Re-examined by Mr. PICKFORD

1
2 Q Mr. Shuttleworth, you were taken to a Transco Holdings Plc annual report. It is at bundle
3 SD1, tab 11. Could you turn, please, to p.705. A. I have that page in front of me now.

4 Q You will recall you were taken to a paragraph beginning “Most importantly”? A. I do.

5 Q Can you just refresh your memory of that paragraph. Can you clarify what, if any, is the
6 relevance of that to the metering assets? A. The reference to the figure of £2 billion
7 implies that it is discussing the focusing in relation to the division of value between the
8 transportation business in general and the storage business, where that particular figure
9 arises. Since the transportation business at that time bundled pipelines, i.e. transport and
10 metering, it has actually no specific or immediate implications for the value of the metering
11 business as a stand-alone business.

12 Q Thank you, I have no further questions.

13 PROFESSOR STONEMAN: Could I just follow that on. The whole idea of the regulatory asset
14 value is that National Grid has a price cap imposed upon it that in a very general sense is a
15 regulatory asset determined partly by the regulatory asset value times the cost of capital.
16 That is basically operating costs, yes. Now the greater is the regulatory asset value, the
17 higher is the price that it charge for a given cost of capital. So if the regulatory asset value
18 is increased by £2 billion in the transmission business, it can get the agreed rate of return on
19 capital on an extra £2 billion? A. And, indeed, the extra depreciation on that.

20 Q Yes. And if that regulatory asset value has been increased in the transmissions business in
21 order to allow for some stranding in the meter business. then National Grid is being
22 allowed, it may not actually have done it, allowed to generate extra revenue in transmission
23 to cover that stranding? A. Sorry, that decision to which that is referring, this increase in
24 the value of the combined transportation business by £2 billion tells you nothing about what
25 will be done with the specific value of the metering business once it is open to competition.
26 That is a separate decision.

27 Q I accept that, all I am trying to get at is if that £2 billion reflects the possibility of stranding
28 in the metering business, which is what Ofgem have argued that it does ---- A. No, that
29 £2 billion is the difference between a hypothetical focusing which, as I say, was never a real
30 possibility, and a value placed on the transmission business in 1997 when metering was not
31 being discussed as a separate business, there was no consideration of stranded costs in
32 metering whatsoever. So I do not think that figure is at all related to the potential stranded
33 costs in metering.

34 PROFESSOR STONEMAN: That is fine, thank you.

1 THE CHAIRMAN: Can I just be clear, Mr. Shuttleworth, were you involved for National Grid,
2 or for anybody else, in an advisory capacity at the time of the investigation in to what
3 should be the price control that was settled in 2002? A. No, I wasn't involved at all.

4 Q So you do not know, from your own knowledge, whether this focusing or unfocusing was
5 treated by the industry participants as a *quid pro quo* regarding stranding or not? I know
6 you say there is nothing to suggest that it has any link, but you do not know from your own
7 involvement in that exercise whether it had a link or not? A. That's correct, I am
8 commenting on the basis of the decisions that were going on around at the time, and the
9 regulatory environment at that time.

10 THE CHAIRMAN: Thank you very much, Mr. Shuttleworth, I can release you from the witness
11 box.

12 (The witness withdrew)

13 MR. TURNER: Madam, our next witness is Dr. Mark Williams.

14 Dr. MARK WILLIAMS, Sworn

15 Examined by MR. TURNER

16 Q Could Dr. Williams please be provided with a bundle marked WS1. Dr. Williams, when
17 you have WS1, please turn in it to tab 4, beginning on p.859, do you have that? A. Yes.

18 Q You see there a report marked "Assessment of Market Power Legacy Meters", could you
19 now turn to p.902? A. Yes.

20 Q Is that your signature which appears under the declaration on that page? A. It is quite
21 faint, but yes, I believe it is.

22 Q Is this report your first report for the Tribunal in these proceedings? A. Yes, I believe it
23 is.

24 Q Would you now please take up bundle WS6?

25 THE CHAIRMAN: You say you "believe" it is, Dr. Williams – is it or is it not? (Laughter)

26 A. Yes, it is.

27 MR. TURNER: If you turn in that to the first tab which is marked tab 22 you will see a page,
28 3055 entitled "Normal Competition Market Definition and Dominance, Second Report of
29 Mark Williams". If you turn to p.3100, the bundle numbering (p.43 internal numbering)
30 you will see a more definite signature there. Dr. Williams, is that your signature?

31 A. Yes, it is.

32 Q And above it is that your expert declaration? A. Yes, it is.

33 Q And is this your second report? A. Yes, it is.

1 Q Dr. Williams, finally, if we turn within this bundle to p.3109 there is a document marked:
2 “A note on economic aspects of Gas Metering Markets”. Can you explain what this is?

3 A. Yes. This is a note that was prepared by NERA, the firm for which I work, to submit to
4 Ofgem during the Administrative procedure, I believe in response to the first statement of
5 objections. I say it was submitted by NERA, however I was the principal author of this
6 report.

7 Q Is there anything in your report for the Tribunal that you would now wish to qualify or
8 correct? A. No, there is not.

9 MR. TURNER: Dr. Williams, if you wait there other counsel will have questions for you.

10 A. Thank you.

11 Cross-examined by Miss CARSS-FRISK

12 Q Dr. Williams, focusing, if I may, first on what you say about market definition - mainly
13 your first report - just to try and be clear about what you are saying, looking at para.13,
14 p.866 of that bundle, WS1. In para. 13, as I understand it, you are complaining about
15 Ofgem’s market definition saying that it “merely rests on the following claims” and
16 observations” and then you set those out (a), (b), (c) in that para.13? A. Yes.

17 Q That is a sort of summary, is it not, of your complaints about Ofgem’s market definition?
18 A. Yes.

19 Q The first argument you raise, as I understand it, that is your section 2.1 is that legacy new
20 and replacement meters are fundamentally different - yes? A. Yes.

21 Q Just looking at your definition of a legacy and a new and replacement meter, are you here
22 referring to a legacy meter as a meter where the costs have been sunk as at 1st January 2004
23 or not? A. No. Throughout my analysis I have always intended that when I have used
24 the word “sunk” – I am speaking here as an economist, I mean whether it was sunk at the
25 relevant moment in time, which is the moment usually in which the contracts were being
26 negotiated. So if there is any discrepancy between what I regard as the legalistic definition
27 about a particular date and when the contracts were actually signed I am meaning here the
28 moment the contracts are negotiated and signed, or in some contexts when the assets were
29 installed, but not the 1st January thing.

30 Q Yes, I see. Looking at why you say that Legacy and new and replacement meters, as you
31 have defined them, are fundamentally different, is it right that it is really about the fact that
32 legacy meters were already installed and costs sunk at the time when the MSAs were
33 signed? That seems to be what you are saying in para.15 in particular? A. You say “all

1 about”, certainly I believe a fundamental aspect of it is, yes, they were sunk at the time that
2 the contracts were negotiated, yes.

3 Q If you were to just turn back in your report to p.865, the extract that you cite from the
4 Authority’s decision above para. 11 on that page -- One sees in the second half of that
5 extract the Authority says,

6 “Grid has referred to the conditions of competition being different for Legacy
7 meters and new and replacement meters on the basis that Legacy meters had
8 already been installed whereas new and replacement meters were not installed
9 when the MSAs were signed”.

10 Can we at least agree that one has Ofgem referring there to that distinction that you say is
11 important? A. Well, this text is, I think, written by Ofgem.

12 Q Yes, it’s from Ofgem’s Decision. In that paragraph that has just been quoted to me, it’s
13 referring to National Grid having referred to this. So, yes, I mean, this is an Ofgem decision
14 and it refers to some text where it says that National Grid referred to this. I don’t know
15 whether this is Ofgem referring to it, but, yes, this is an Ofgem piece of text.

16 Q It is Ofgem putting on record, is it not, that they are aware of the argument that it makes a
17 difference, or is significant, that Legacy meters had already been installed whereas new and
18 replacement meters had not? A. It is clearly Ofgem acknowledging that they have read
19 this reply. I don’t have any idea whether, in a sense, there is any sense in which Ofgem are
20 acknowledging the validity of the argument, but they are acknowledging the existence of
21 the argument.

22 Q Yes. Moving on from there, if I may, to your third complaint, as I understand it, about
23 Ofgem’s market definition, which is your s.2.3 in your report at p.867, you say,

24 “New and replacement meters and Legacy meters are not good substitutes”.

25 Your core reasoning there, as I understand it, is in para. 19(a) and (b). A. I think in para.
26 19 I have 19(a), (b), and (c). So, in terms of core reasoning, just looking over this quickly --
27 I think the reason I put down three reasons is that there were three reasons in my mind.

28 Q All right. I shall focus in a moment on the reasons given at 19(a) and (b). But, before I do
29 that, I hope it is common ground that demand size substitutability is generally taken to be a
30 particularly significant consideration in relation to market definition. A. Yes.

31 Q As I understand your paras. 19(a) and (b) your argument is that where you have a meter
32 rental contract that provides for payment completion, i.e. it includes some form of exit
33 charge or PRC, there will not be an economic incentive to replace a Legacy meter with a
34 new and replacement meter. A. I say what I say in that paragraph. I mean, I can

1 summarise it, if you want. I mean, in para. 19(a) I essentially talk about the economic price
2 of continuing to consume the services. I point out that they have already installed the costs,
3 whereas, of course, in the case of a genuinely new and replacement meter, that sunk cost
4 would not have been sunk.

5 Q What you also factor into that at para. 19(a), if we look towards the end of that sub-
6 paragraph, is that you are assuming normal and competitive conditions, i.e. that provide for
7 payment completion or an equivalent arrangement such as sale. Do you see that in the final
8 sentence of para. 19(a)? A. I say that, yes.

9 Q Yes. Then, at para. 19(b) you say, "The reason why gas suppliers considered an accelerated
10 replacement of Legacy meters with new and replacement meters after de-regulation was that
11 normal commercial and competitive payment completion arrangements did not exist for
12 National Grid's Legacy base".

13 A. If I can just slightly clarify -- I say that this is the reason they considered it.
14 Obviously, I don't know about their mental states, but the reason why it was a sort of thing
15 to be worth thinking about was because of the absence of that contractual protection.

16 Q But, in this case, at the time when the MSAs were entered into, looking at the situation then,
17 of course, there was no provision for payment completion in relation to the Legacy meters.
18 That is right, is it not? A. Before the MSAs were signed there was no provision for
19 payment completion, yes.

20 Q No. So, at that time, against that background, meters that had not yet been installed - new
21 and replacement meters, if you like - were, were they not, demand size substitutes for
22 Legacy meters? A. Ah! Okay. (After a pause): Right. When we do market definition
23 we normally want to understand our products substitute, etc. when you've got normal
24 competitive conditions. So, for example, sometimes if you've got a monopoly you can have
25 a situation where another product appears to be a substitute to it. But, that is only actually
26 because monopoly power has already been exercised. Here, in a sense, this is a situation
27 where we have abnormal competitive conditions, and, in a sense, these things are in the
28 market only because, in a sense, of the absence of normal competitive arrangements. So, I
29 think this may go to explain the paradox which I think I may have even have ... mention on
30 this one, which was that there is a slight dilemma here, which is that on the one hand I am
31 saying that, in a sense, they are not in the same market, but on the other hand it is absolutely
32 my view that the threat of new and replacement is exercising a significant disciplinary role
33 on them. So, I think that may hope to go to explain, in a sense, why there is this potentially
34 slightly paradoxical view.

1 I should also emphasise that, you know, this is not the full extent of the reasons why I
2 partition the markets, but this is one of the factors, and I hope I have tried to explain, in a
3 sense, what appears at first to be a slight puzzle.

4 Q You are making then the assumption, it seems, as to what the competitive situation would
5 have been like, and you are completely ignoring the reality of the situation as the market
6 was, and as the contractual position was as at January 2004. A. If I go back to what I said
7 before, if one was thinking about relevant market definition -- If I go, for example, to the
8 monopoly case -- the monopoly would be the reality of the market, but if one tried to argue
9 that the thing was a substitute, even though the monopoly was the reality, you would say,
10 "No, that's not in the market. The only reason it's competing with you is that the price here
11 is abnormally high".

12 THE CHAIRMAN: The Cellophane Fallacy A. Effectively Cellophane Fallacy, yes. So, yes,
13 in a sense I have ignored the reality because that is, I believe, what one is meant to do.

14 MISS CARSS-FRISK: You have, as I understand it, accepted that certainly the new and
15 replacement meters do provide a constraint on National Grid at this time. That is right, is it
16 not? A. Absolutely. I believe that at this moment in time, notwithstanding my views on
17 appropriate classification, that precisely because National Grid had not got in place the sort
18 of normal payment completion arrangements, that, yes, they were exposed to threats,
19 including stranding, and that therefore the possibility of replacement was quite a scary
20 possibility for them, that influenced the pricing that they set.

21 Q On that basis I would suggest it was legitimate for Ofgem to take the view that Legacy and
22 new and replacement meters were indeed in the same market. A. As I think I've just
23 explained my reasoning for why I classified it as in separate markets, notwithstanding that
24 there was an effect on their pricing, I think I can only repeat my previous comment - though
25 I would be willing to add other reasons as to why I've had this classification, including, if I
26 may note, the point in (c).

27 Q Moving on to your para. 20, you refer to the geographic market. You make the point, as I
28 understand it, that each Legacy meter is in a world of its own effectively due to sunkness. Is
29 that right? A. Paragraph 20 ----

30 Q Paragraph 20(a). A. Yes.

31 Q Does it follow that any meter actually is in truth in a world of its own on your view once
32 costs have been sunk? A. In market definition there are strict processes that one is meant
33 to go through. If you go through these strict processes and start asking about genuine
34 substitution possibilities, and I think I have expanded on this in my second report, it is true

1 that once an asset is sunk at specific premises, it's a customer specific sunk cost, then
2 actually it can't be used for next door. Basically, if you do a proper form analysis of it, if
3 they want to read how much gas I've used, it's no good knocking on my neighbour's door
4 and wanting to look at that person's reader. Basically, these things are not technically
5 demand substitutes for each other. I might also add that this method of actually noting that
6 you get a very large number of, if you like, personalised markets is not an original idea that
7 I've introduced in this case. I think it is seen in other contexts.

8 Q Just to be clear, that is, as it were, the logic of your argument, that we have a very, very
9 large number of separate markets then? A. The strict logic is that for the sunk costs, in a
10 sense, they are, as I put it, in a world of their own. I do not deny that in circumstances
11 where one has this very large number of individualised markets, especially as, in fact, the
12 relationships there may be very similar, one for another, for practical purposes one might
13 sometimes want to just one might sometimes think of as an aggregation market. So you
14 lump them together for practical purposes, but I think it is important to recognise that when
15 you do that traditional connections one might have between market share and market power
16 do not necessarily read over when you've done that.

17 Q Dr. Williams, moving on to what you say about dominance, and still in your first report, you
18 refer, as I understand it, to three main reasons why you say Grid was unable to exercise
19 market power in relation to the Legacy meters, that is sunkness, price regulation and the
20 outside options of customers – is that right? A. Yes, can you give me a specific reference
21 here?

22 Q For example, in para.60 on p.877, you appear to be summarising the argument in that way.
23 You see the second sentence of para.60:

24 "I consider that for the three reasons stated – sunkness, price regulation and the
25 outside options of customers – it could be expected that National Grid would not
26 have been able to exploit any market power over Legacy Meters ..."

27 Then you refer to the market evidence? A. Yes, those are the three factors that I think
28 come together to provide the basis for my conclusion.

29 Q If we take the first of those factors, "sunkness", that you deal with in para.38 on p.873, and
30 your point is, as I understand it, that buyer power will be greater when costs have been sunk
31 as in relation to the Legacy Meters? A. At a high level of summary, that is what I said.

32 Q A high level of summary? A. I might put more detail, but at a high level of summary,
33 yes.

1 Q As I understand it, again no doubt at a high level of summary, that is because, assuming that
2 the meter has no value outside that trading relationship, the owner would be willing, if
3 pressed, to accept any price above avoidable cost? A. One can't say about exactly what
4 price they would be forced down to, but there is no doubt that if one has already sunk the
5 asset before signing the contract and there is nothing else you can do from it, basically you
6 may find yourself in situations where you are being offered a low or very low price for it,
7 and you haven't got any other alternative. The conclusion I would push with very strong
8 backing is you're almost certainly not going to get your costs back. Quite how far below
9 that you end up, an interesting debate, but you're not going to get your costs back.

10 THE CHAIRMAN: You are not going to get your total costs back? A. We can debate how far,
11 but that's the one statement I would make that I feel ----

12 Q If your marginal costs are nominal, then you would be prepared to go down to practically
13 any price in order to get some money rather than no money? A. If you spent £100 on
14 something and there is nothing else you can do with it, and somebody can make you an
15 offer of £1 then, if you're going to get zero, £1 is better than zero.

16 MISS CARSS-FRISK: As I understand it, you do, however, agree with Professor Grout in
17 principle when he says that the fact that an incumbent has sunk its costs may, in fact, have
18 the effect of deterring entry and may, in that sense, be an advantage for the incumbent?
19 A. I think it's very important to be clear about – this is my interpretation, you'll have to ask
20 Professor Grout – where we do and where we don't agree. In his report Professor Grout
21 provided a stylised account of how sunk costs can deter entry into a market. If I may briefly
22 summarise that, it says something like the following: if firm A is the incumbent firm and
23 spends £100 on a cost that is fixed and then sunk, and let's suppose the marginal of
24 operation is zero, to keep it very simple, then if, having not yet signed a contract, firm B
25 were to enter the market and sink its cost of £100, then you would have both A and B in the
26 market, both having sunk their costs, and then competing on price, one could well expect
27 that the price competition would be very intense indeed, *in extremis* all the way down to
28 marginal cost, and basically one of them would win the contract but neither of them would
29 make any money and they would both lose. Therefore, that is, in a sense, the final stage of
30 the game. Therefore, lastly, anticipating that that would happen, then once firm A had sunk
31 its cost, firm B would quite rationally stay clear of the situation because, if it goes in, it will
32 be bad for B. It will be bad for A as well, but that's not what's driving B, it's that it will be
33 bad for B. This is a well known model of competition, it's generally known as a strategic
34 entry deterrent. There are models where you basically sink your cost and at that point

1 nobody in their right mind would enter your market. Therefore, a crucial point, you've still
2 got pricing flexibility. Now pricing flexibility at this point, the fact you haven't signed a
3 contract, plays two roles in this story. The first is that if they were to come in the price
4 would go very low indeed. So that's what scares them out. But then, when they stay out,
5 you've then got pricing flexibility to set any price, including all the way up to the monopoly
6 level. I believe Professor Grout characterises it in different ways, but I believe that he refers
7 to models of this category. In response to the question that has been posed to me, I
8 acknowledge the existence of this model. It is extremely well known. There are numerous
9 people in this room who will have taught this model, etc, etc. So we are, as I see it, in no
10 way disputing that that model exists and is relevant, and that the conclusion of that model is
11 that sunk costs can deter an entrant. That is where I draw a line, because I think that is the
12 point where Professor Grout and I, where our agreement ends. I now want to explain why I
13 disagree.

14 THE CHAIRMAN: Can you wait for Miss Carss-Frisk to ask you questions. We have your
15 evidence and we have read that evidence and we will re-read it, so really you do not need to
16 give us that evidence again. You only really need to answer Miss Carss-Frisk's questions.

17 MISS CARSS-FRISK: I am grateful, madam. Professor Grout, as I think you acknowledge,
18 takes the view that it is not of crucial significance here where the potential new entrant has
19 to sink its costs before the bargain is struck or not. He says, in effect, the mere knowledge
20 by the potential new entrant that incumbent has all those sunk costs and is therefore likely to
21 compete very aggressively on price. The mere knowledge of that may deter someone from
22 seeking to enter the market even in a situation where it might be possible for them to strike
23 the bargain before they sink their costs, particularly in a case where there are barriers to
24 entry anyhow because of the need for economies of scale and density in the particular
25 market? A. Right. This is the basis of the disagreement I think. I explained in my
26 previous answer why, if they sunk the costs and entered before having the contract, there
27 would be vicious price competition and I accept that anticipating that they would stay out.
28 But, if you are smart, what you will do as an entrant is, recognising that, you will stay out if
29 the only way to come in is to sink and then compete on price. If the entrant is smart what he
30 will do is to basically arrange the contract and then 10 seconds after he has the ink on the
31 paper – only at that point – sink the cost when he has the asset in the sense protected by a
32 contractual revenue stream. I would also suggest that that is, in addition to being my, in a
33 sense, view as an economic theorist about what you would expect to happen is also what, in
34 the market context, did happen.

1 Q Dr. Williams, I am sure it is entirely my fault, but it is still not clear to me why you are not
2 accepting that it might indeed be the case that a potential entrant is going to be put off
3 simply realising that here is an incumbent, let us assume (as in this case) with a very large
4 asset base and likely to compete therefore aggressively, why may that not in reality be the
5 case? A. I think I go back to my previous answer, which is if the only form of
6 competition available to them was, if you like, spot competition then the point that has been
7 put to me would be valid, but it is not the only method of competition and that securing
8 contractual protection before making the commitment (a) is available theoretically, and (b)
9 was actually the route chosen, I believe.

10 THE CHAIRMAN: Why would the customer be prepared to give potential entrant (b) that
11 protection for his sunk costs if he thinks that he does not have to give that protection to A,
12 and therefore A will have the incentive to lower his prices to marginal cost? A. I
13 understand the question, this is the essence of how this game worked. If the customer were
14 not prepared to offer a long run contract to the entrant, then as has just been described, the
15 entrant would rationally stay out. If the entrant cannot reasonably be expected to come in
16 then at that point British Gas – to take an example of a representative customer – does not
17 have a stick with which to threaten National Grid at which point in fact National Grid would
18 then be in a position to raise its price, albeit constrained, of course, to the monopoly level,
19 unlike in the standard monopoly case, therefore it is willing to sign a contract with an
20 entrant, as in fact has happened in some cases, and it is entirely plausible they will, provided
21 the terms offered by the entrant are better than the terms being offered by National Grid,
22 and therefore the recognition that it is rational to sign those contracts forces National Grid
23 to competing contracts, and I think that is what it actually saw in the market. So in some
24 cases the entrant won a contract, but in other cases what happened is that the entrant in a
25 sense was competing, in a sense, for the contract but the rational anticipation they were
26 competing for the contract forced National Grid to lower its price, and I am obviously not a
27 witness of fact but I have seen some of the documents on that, and therefore the threat of
28 entry was what forced National Grid to lower their price. If I may add, this is also another
29 feature on the market definition.

30 One of the purposes of doing market definition is that you can then work out market shares,
31 and when we are measuring in this market things like shares and new and replacement, one
32 can measure - the contracts for new meters have actually been signed – they have got some
33 mass, But one of the things about this threatened competition is that because in fact the
34 entrant in these contexts never actually won the contract, what one has is a situation where

1 National Grid was forced to reduce its prices significantly by threatened contracts that never
2 came into existence and which, in a sense had no measurable mass. So that if, for example,
3 one did include them in the market definition, in a sense you would be including something
4 there which would have a huge competitive impact but was not measurable in any way.

5 That would then render ----

6 THE CHAIRMAN: It is a potential rather than an actual market? A. Yes, so it's potential
7 competition that is doing it and that is why, consistent with my understanding of all the
8 guidelines that I have operated with in my professional consulting career, demand
9 substitutes are in the market, supply substitutes nobody can quite make their mind up
10 whether they are in the market or out of the market, but the threat of entry from without it
11 can be powerful, but it is not normally classified as in.

12 MISS CARSS-FRISK: Of course, Dr. Williams, I know you are not a witness of fact, but it is
13 true that there were competitors in the market at the time when the MSAs were signed, there
14 were some commercial meter operators in the market at the time. I am sure you are aware?

15 A. It depends what you mean by "in the market". Does one mean in the market place
16 actually supplying ----

17 Q Available to compete with Grid? A. There were companies who were clearly in the
18 position competing for contracts with Grid, but notice here, Grid had already sunk the asset
19 whereas these companies that were competing against what eventually turned out to be the
20 MSA were operating at a level where they had not sunk the costs but National Grid had. So
21 in a sense there was some sort of competitive interaction between them but they are
22 operating in a sense at sequential stages of what you would normally think of as a supply
23 chain.

24 Q Dr. Williams, changing back to where we were in relation to what Professor Grout has said,
25 would you accept his thesis that even if the incumbent's sunk costs do not have the effect of
26 deterring entry altogether, they certainly may affect the terms on which a new entrant may
27 enter the market so that, for example, the new entrant may seek greater contractual
28 protection than it otherwise would? A. I noted Professor Grout's reference that it would
29 affect the terms. One initial observation of course is the fact that the costs were sunk means
30 that National Grid would, if necessary, compete very vigorously, so certainly that aspect of
31 it would make the entrant need to offer very aggressive pricing to have any hope of getting
32 in.

33 The second part of the question I have just been asked is: would it affect the nature of the
34 contracts? I think the hint of this argument is that they demanded long term protection

1 because of Grid's presence. Now, I do not dispute that they would want protection because
2 basically it would be crazy to sink the asset, go into the market without that protection for
3 the reasons I have just described, but I believe that they would ask for that protection even if
4 National Grid did not exist. Why? Because suppose they were to sink the asset and go into
5 the market three years down the line what position would they be in? Three years down the
6 line they would have sunk their assets at 15 Arcadia Avenue, etc. They would not have a
7 long run contract in place, and they would find themselves in a position essentially the same
8 that National Grid found itself in which, as I have argued and I think most people agree,
9 was not hugely comfortable position to be in, so actually even though I think they would
10 have asked for protection obviously against National Grid, I believe that they would
11 rationally have wanted that protection, even if National Grid did not exist, in order to avoid
12 themselves three years down the line being in exactly the same position that National Grid
13 was at the time they signed the MSAs, so I reject that implication.

14 Q Would they not be more likely – more likely – than otherwise to seek such protection, given
15 the status of Grid as the incumbent with all its sunk costs, etc? A. The analysis I have
16 just given said that basically I believe it would be entirely rational for them to seek that
17 protection even in the absence of National Grid. The exception would be, of course, if they
18 were paid so much money up front that effectively they had already been paid the cost
19 anyway, but on any what you might call 'even path' of payment. So since I basically say it
20 is my belief that they would with probability 1 (or close to 1) seek that protection. In the
21 absence of National Grid. I do not believe it actually increased their likelihood because you
22 cannot increase the probability above 1.

23 Q Would you go please to para.73 of your second report, and I am afraid I am going to have to
24 ask you to jump a little bit between your first and your second report. Page 3082 of WS6.
25 This is where you respond to Professor Grout's argument about sunk costs strengthening the
26 position of the incumbent. You say:

27 "However, it is worth remarking that Professor Grout's reasoning does shed light
28 on the question of what outcome we might expect to observe. If Grid has sunk its
29 costs and the entrant has not, then the efficient outcome will typically involve the
30 entrant not sinking a duplicated cost and supply will likely be made by the
31 incumbent. In that regard I would not expect an accelerated replacement of Grid's
32 Legacy meters and, as I explain in more detail in s.4.2, accelerated replacement
33 would not be the socially efficient outcome".

1 So, as you say, Professor Grout's reasoning does shed light on what you might expect to
2 observe, which is basically a low level of meter replacement if we apply it to this particular
3 case. Is that right? A. I notice that this section of my text was repeated, I think, in some
4 of the arguments, in the skeletons, or something. Could I just draw attention to one thing,
5 which is that the paragraph that was just quoted was terminated one sentence before the end,
6 and that my last sentence, which was after where it was cited, says,

7 "However, in terms of price setting the threat of stranding of sunk assets places
8 severe discipline on the pricing by National Grid".

9 So, to summarise what my position is here, it is true that -- I apologise for the fact that this
10 is now moving to slightly economic terms -- I believe that because of the cost structure then
11 in equilibrium it is overwhelmingly likely that National Grid will actually supply because
12 they have sunk their cost and will basically out-compete any entrant there because they have
13 got the sunk and potentially stranded cost. So, I believe that it is very likely that National
14 Grid will actually win the contract because of the cost asymmetry. That is separate from the
15 question of whether or not, even though I never actually expect the entrant to win the
16 contract, as to whether the threat of the entrant winning the contract can be used to drive the
17 price down.

18 So, in a sense, yes, I say what I say in para. 73. I stand by it. I merely say that I believe that
19 you can't read all of para. 73 without also reading the last sentence.

20 Q Thank you, Dr. Williams. Still in this particular context, you have also included in your
21 response to Professor Grout the reference to the hold-up problem which you say that he has
22 ignored. For your reference it is your second report, and particularly paras. 6(b)(ii) and 54
23 and 57 on pp.3060 and 3077. A. Sorry. I didn't keep all of those numbers in my head.
24 Do you want me to turn to a particular page?

25 Q If you would go to p.3060, I just want to be clear that I have understood that those are
26 indeed the passages where you make that argument. It is para. 6(b), first of all, is that right,
27 where you refer to the hold-up problem? A. I am trying to find the word 'hold-up'. Yes.

28 Q Similarly, in paras. 54 and 57 of your second report at p.3077. (After a pause): A. At
29 para. 54(a), yes. I mention the hold-up problem there.

30 Q This is really you saying, in a sense, what we have, I think, already looked at - that when a
31 supplier has made a relationship-specific investment before the terms of the contract has
32 been agreed puts him in an inherently weak position. A. I've already said that because
33 their costs are sunk I believe they're in a fundamentally weak bargaining position. I have
34 also been asked about the hold-up problem and, briefly, the hold-up problem is a

1 characterisation of a situation which is, in my view, essentially the same as the one we have
2 here. You have made the investment. You have got no other use for the asset. Basically at
3 that point you are vulnerable to a very bad outcome. So, yes.

4 Q There is not going to be a hold-up, is there, if there are no realistic outside options? A.
5 Sorry? Could you repeat that?

6 Q If there are no realistic outside options for the customer, then there is not going to be a hold-
7 up. A. Ah! For the customer. Sorry.

8 Q For the customer, yes. For the customer. A. So, I think the point that's being made here
9 is the following: one has a firm that's made an investment and it's got no other alternative
10 use for it, except to deal with this customer. Now, of course, there are two possibilities.
11 One is that the customer might no longer want the product in question. So, actually, it's still
12 true that you can have a hold-up problem even if the customer has no other outside option,
13 if the customer is no longer interested in buying the product. However, if the customer is
14 still interested in buying the product, then I would accept that basically you would expect
15 them to come to a sensible arrangement. It would still be a ballot or bargaining game, but
16 basically -- So, there may still be some hold-up, but it would not be as severe as if they do
17 have an outside option.

18 Q There would be no real hold-up if you have a situation where the customer has no option
19 but to deal with the incumbent. A. Going back to my previous answer, I didn't quite say
20 that. I did say that there may still be a hold-up problem because there was still a bargaining
21 outcome there. Who knows? Bargaining is often very difficult to predict the outcome of.
22 So, I disagree that there was no hold-up, but I do confirm that the hold-up will be more
23 severe if, in addition to that, they have an outside option as well.

24 THE CHAIRMAN: If they do not have an outside option and they have to have this product in
25 order to carry on their own business, then there cannot really be a hold-up problem, can
26 there? A. No. Basically, suppose two people are in the situation where A has something
27 that B wants, and B has something that A wants -- or B has something they want from A.
28 Basically it is worth zero to Person A and 100 to Person B. As a matter of economics what
29 can you say? What you can say is, I think, the following, which is going to be rather trivial,
30 I am afraid: that a contract ought to be agreed because there's a gain from trade, and the
31 price will lie somewhere between zero and 100. The whole economics of bargaining
32 theory is about, "Where in that range do you settle?" You know, it's a matter that is
33 intellectually great fun, but after 100 years of progress I am not sure we're much closer to
34 working out exactly where you settle.

1 MISS CARSS-FRISK: Would you accept that if the incumbent is able to set its prices above the
2 prices being offered by such competitors as there are, then there is not going to be a hold-
3 up? A. No. Possibly, but it depends on the circumstances. The hold-up problem that
4 we've been talking about is the situation where an asset was invested at Cost 100. Basically
5 whether or not there's a hold-up depends on whether they can recover 100 or not. The
6 answer to the question therefore depends on precisely what the prices offered by the
7 competitors are. So, there are some price levels - including ones relevant in this case -
8 where there would still be some partial hold-up of the asset in that you failed to recover all
9 of the asset that you had invested.

10 Q That probably takes us to your second feature, as I understand your report - the second
11 reason why you say there was not dominance on the part of Grid here. Grid, you say, was
12 constrained by the regulated price cut. You deal with that in paras. 40 to 41 on p.874 of
13 your first report. I do not know whether you just want to refresh your memory of those
14 paragraphs? A. If I may. (After a pause):

15 Q I notice the time, madam. I am entirely in your hands.

16 THE CHAIRMAN: I do not wish to intervene in your cross-examination, Miss Carss-Frisk.
17 Could you give us an indication of how much more you have for this witness?

18 MISS CARSS-FRISK: I am afraid I might be perhaps an hour.

19 THE CHAIRMAN: We will break there if that is a convenient point.

20 MISS CARSS-FRISK: There is also one housekeeping matter which is that the table that Mr.
21 Turner referred to that Mr. Matthew was going to provide us with tomorrow morning. Now,
22 we, of course, really do need a chance to digest what is going to be in that table. I would
23 suggest that, in fairness, we ought to have access to that today, particularly as Mr. Matthew
24 is going to give his evidence tomorrow.

25 THE CHAIRMAN: Is that possible, Mr. Turner?

26 MR. TURNER: It is not possible. It is not yet ready.

27 THE CHAIRMAN: Perhaps counsel can make an arrangement that as soon as it becomes ready
28 then it should be sent over to the Ofgem team.

29 MR. TURNER: We will undertake to do that.

30 MISS CARSS-FRISK: Madam, I have to reserve my position in relation to that. I think it was
31 actually asked for on the first day, but here we are on Day 6 ----

32 THE CHAIRMAN: Yes, it was. Let us see when you have a chance to look at it. If you do not
33 feel in a position to ask questions to Mr. Matthew straightaway on it, then we may have to
34 think about recalling him once you have had the opportunity to consider the table.

1 MR. TURNER: Madam, there is one matter also that I neglected to mention in examination-in-
2 chief. Perhaps it was clear enough in any event. Professor Stoneman asked about the
3 annexe to the National Grid skeleton and at that time I mentioned that Dr. Williams was the
4 man to be dealing with those issues. Just to clarify, that is the case ----

5 PROFESSOR STONEMAN: I was hoping to deal with that tomorrow now.

6 THE CHAIRMAN: Would it be a good idea for us to start a little earlier tomorrow to make sure?
7 Could we start at ten tomorrow morning?

8 MISS CARSS-FRISK: Yes, certainly.

9 THE CHAIRMAN: Does that create difficulties for anybody?

10 MR. TURNER: Madam, I do not think it does. I do not know how long my friend is expecting to
11 spend with Mr. Matthew, but I believe that if he is reasonably short as well, we probably are
12 back on course with the experts. So, it may not be necessary.

13 THE CHAIRMAN: Let us start at ten, as I am generally pessimistic of these things.

14 MISS CARSS-FRISK: Having said that, I would actually agree with Mr. Turner - that I do not
15 think I will be very long with Mr. Matthew.

16 THE CHAIRMAN: If we start at ten and we can all finish a little earlier then I am sure that will
17 be welcomed by everybody. Mr. Williams, is that all right with you? Can you come at ten
18 o'clock tomorrow morning? A. That's fine, yes.

19 THE CHAIRMAN: You are in purdah, as I am sure you understand. So, you must not discuss
20 any of this with your team. We will resume then at ten o'clock tomorrow morning.

21
22 (Adjourned until 10.00 a.m. on Friday, 23rd January, 2009)
23
24
25
26
27
28
29
30
31
32
33
34