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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1099/1/2/08

Victoria House,
Bloomsbury Place,
London WC1A 2EB

23rd January 2009

Before:

VIVIEN ROSE
(Chairman)
PROFESSOR PAUL STONEMAN
DAVID SUMMERS

Sitting as a Tribunal in England and Wales

BETWEEN:

NATIONAL GRID PLC

Appellant

- v -

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

supported by

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

Interveners

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HEARING (DAY 7)

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.

Ms 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: Good morning. We have received your table, Mr. Turner. We assume that
2 the Ofgem team saw this at some point this morning.

3 MISS CARSS-FRISK: Actually last night, madam.

4 MR. TURNER: It was e-mailed to everyone at the same time, madam. What you have there is a
5 hard copy which I think has some of the supporting material at the back.

6 THE CHAIRMAN: Nonetheless, Miss Carss-Frisk, if you need more time in order to prepare any
7 questions on that, then, please do say.

8 Dr. MARK WILLIAMS, Recalled

9 Cross-examined by Miss CARSS-FRISK, cont'd

10 Q Dr. Williams, I would like to go back for a moment, please, to the topic of market
11 definition, focussing again on your paras. 19(a) and (b) in your first report at WS1, pp.867
12 to 868. When you were asked about this yesterday you suggested, as I understood you, that
13 it was appropriate to ignore the reality of the position at the time when the MSAs were
14 negotiated and to consider what would have been the degree of substitutability if Grid had
15 had in place contracts that provided for payment completion at that time. That is right, is it
16 not? A. I believe that is what I said, yes.

17 Q In answer to a question from madam chairman you said that this was effectively referring to
18 the so-called Cellophane Fallacy. A. Ah! Well, not quite. What I said was that for the
19 purposes of market definition one needs to ascertain this in a competitive world. In order to
20 get that across I gave an example which we are all familiar with of where, in another
21 direction, basically when you have the cellophane case -- where basically he's saying, "Just
22 because it's in the market, because it's monopolised it doesn't mean that's the appropriate
23 benchmark and one should look at it under competitive conditions". So, my reference to the
24 Cellophane Fallacy was a reference to the question from the chairman. But, if I can make
25 myself precise here, what I'm basically saying is this: in this case -- You will see in this
26 paragraph that I use the phrase 'economic price'. So, that is prices, which are prices as we
27 normally understand them. Then there is the economic price. The economic price under a
28 payment completion contract is essentially set so that it is effectively equal to marginal cost.
29 Under normal arrangements where payment completion contracts are in place, that is the
30 effective price. What I am saying is that for purposes of market definition, that, in a sense,
31 is what you would normally expect to be operating in the market and therefore that is the
32 price against which you judge whether or not the N and Rs are a competitive constraint.
33 Now, of course, separately, because of the unusual arrangements in this market there is a
34 period of time when in fact they do not have normal contractual arrangements in place,

1 which is why, in that period of time, in a sense there is an unusual and abnormal
2 competitive interaction between the threat of replacement and the Legacy meters that have
3 not yet got the subject of the contract.

4 So, essentially one needs to separate two things out here. Basically, in market definition --
5 In a sense, market definition is almost irrelevant. It is where do you classify competitive
6 constraints. Nothing about the reality of a market or a case determined by where you
7 classify it. For avoidance of doubt, my view is that on the substantive question of market
8 power I believe that the threat of replacement was a powerful constraint. So, all we are
9 talking about here is, "Where do we classify this?" What I am saying is that one of my
10 reasons for why in this, to me, irrelevant exercise of where to classify a constraint I have put
11 it as outside the market definition rather than inside is that basically if you evaluate it under
12 normal competitive conditions it would be outside. I also stress that there are various other
13 reasons given, including the one I gave yesterday - that in a sense these threats have got no
14 mass and therefore are not measurable for why I hold that view, but that is one of my views.

15 Q Dr. Williams, if you will bear with me, we will continue to engage for a moment still in this
16 irrelevant exercise of market definition as you have described it. As I understood your
17 explanation just now you are saying that there were in fact unusual and abnormal
18 competitive considerations or circumstances at the time when the MSAs were entered into.
19 So, you are saying, "Let's look at what would have been the case in normal circumstances".
20 That is when you would have had payment completion. A. I'm saying that for market
21 definition exercises, one is normally advised to look at this in a competitive world. Since I
22 believe that in a competitive world those contracts would be in place, then, yes, that is the
23 appropriate framework for undertaking the market definition exercise, understanding that
24 that is a separate exercise from assessing market power.

25 Q Yes. Yesterday you did in fact, in response to madam chairman's questions say effectively,
26 'The Cellophane Fallacy, yes', but I understand that you have now elaborated on that in that
27 way. But, just looking at the idea behind the Cellophane Fallacy, as we understand it, it is
28 very much about disregarding any distorting effects of the conduct of the allegedly
29 dominant undertaking. Now, here, you are not alleging any such situation. We are not
30 seeking to avoid the consequences of Grid's conduct as a dominant undertaking, are we?

31 A. No. The abnormal situation here, in the *Du Pont* cellophane case -- The abnormal
32 situation is that *Du Pont* apparently had genuine market power. The abnormal situation here
33 is that one is in a market that was a statutory monopoly that was in the process of
34 liberalising, and for this brief period of time, in a sense, the contractual structures in the

1 market were not the contractual structures that would have been in the market had the
2 market always been competitive.

3 Q What I am suggesting is that if you are not in a situation where you need to guard against
4 the possibly distorting effects of the conduct of the allegedly dominant undertaking, there is
5 no justification for disregarding the reality and assuming certain conditions to apply that did
6 not in fact. A. Sorry? Could you repeat that question, please?

7 Q When you are in a situation when you are not concerned with guarding against the
8 distorting effects of the conduct of an allegedly dominant undertaking -- when you are not
9 in that situation there is no justification for assuming different market conditions to those
10 that actually applied at the relevant time. A. No. I disagree with that. I believe that
11 basically in thinking about market definition -- I believe that all the guidelines I have ever
12 told said, "One should think about that as if it were competitive" and if, as a distortion of
13 that, you modify those distortions before answering that question -- Again, I repeat, and
14 maybe there is some legal reason why this matters, I don't think anything we are saying is
15 about anything to do with whether this constraint exists - merely about where it's classified.
16 I stand by my position on this, which is one of my reasons for why I have it classified as
17 outside the market. I have other reasons as well. I don't think I have further to say on this.
18 I stand by my previous analysis.

19 Q In relation to imagining what normal competition would be like on your thesis, you are
20 assuming that normal competition inevitably would involve a contract with payment
21 completion, are you not? A. Well, the question put to me is that I was 'assuming' that it
22 would. Essentially, I believe that Professor Grout's report also says that some form of
23 payment completion contracts would be a standard feature of normal competition. So, in a
24 sense I don't think I'm assuming it, but, yes, I do believe that to be true.

25 Q You would accept, would you not, that it might be the case that normal competition would
26 be represented by a contract perhaps with no PRCs at all - one where there is competition
27 on price. A. Now, we're currently discussing market definition, and I'm aware that, in a
28 sense, the question that has just been posed to me is almost getting into the abuse questions.
29 Therefore, there's a little bit of intertwining here. But, I will try and answer the question
30 nonetheless. I believe that in the case of investments which are relationship specific and
31 sunk, that basically those investments under normal competitive circumstances are only
32 likely to occur if, in fact, some form of payment completion arrangements are in place,
33 whether that is up-front payment or a PRC, which is basically up-front commitment to
34 eventual payment, in the sense that the cheque may be written later, but the commitment is

1 made just as much as with an up-front payment. When the asset is relationship specific, I
2 believe that is only plausible form which contracts will take. If it's not relationship specific
3 it's quite different because you would have an alternative use, but when it's relationship
4 specific I believe that that is by far the most likely contractual form and possibly the only
5 plausible form.

6 Q On that assumption then you are saying, effectively, that if there were in place a payment
7 completion contract there would be no substitution from new and replacement meters – is
8 that right? A. If payment completion contracts are in place then at that point the
9 economic price of continuing to use the existing meter is essentially the marginal cost, and
10 therefore if you were to think of substitution from a new and replacement meter, that would
11 basically have to incur not just its marginal cost, but also its fixed costs, which will of
12 course become sunk the moment they make the investment. For various of the reasons we
13 discussed yesterday, and other reasons, it is clear to me that it is extremely unlikely that that
14 would be able to compete. In a sense, the cost difference is just too great. One could
15 imagine circumstances where the cost difference narrowed in future. So, in a sense, my
16 claim is not a pure theoretical claim. It has built into it the factual assumption that in
17 present cost conditions, yes, it's true that new meters couldn't effectively compete with
18 existing meters. Yes, that is my view, that thinking of it the other way round, basically you
19 haven't got much of an argument to say that these new meters could economically compete
20 given the cost differential between them, yes.

21 Q Do you say that, although of course looking at the Legacy MSAs that are in place and do
22 provide for payment completion, there plainly is a competitive restraint or constraint from
23 new and replacement meter to some extent, albeit limited? A. Basically, for meters that
24 are coming to the end of their life, etc, when eventually they're going to be replaced, so to that
25 extent, yes, there is competitive interaction, though whether this is actually substitution is
26 unclear. This is almost always going to happen economically when, in fact, the existing
27 meter is effectively not able to deliver services properly.

28 Q Moving back, Dr. Williams, to dominance, where we were yesterday, we had looked at your
29 first feature that you said prevented dominance in this case, which was sunk costs, and we
30 were going to move on to what you have identified as the second feature that prevents
31 dominance, which is that Grid was constrained by the price cap. A. Yes.

32 Q You get your reference to that in particular in paras.40 to 41 of your first report at p.874.
33 A. Yes, this is where we were last night, I think.

1 Q Fast forwarding to what you say about this in your second report, and you may just want to
2 look at that in WS6, para.78, p.3084, you say at the end of para.78:

3 “My core conclusion is that National Grid is no dominant because given the
4 particular circumstances of the bargaining situation it could not have set price
5 above the competitive level, as reflected in the obviously unobjectionable P&M
6 returns.”

7 That, as I understand it, is a summary really of what you had said about the second feature
8 in your first report? A. No, I believe that is a summary of my judgment formed on the
9 interaction of the three constraints. I have mentioned sunkness, I have mentioned
10 regulation, I have mentioned the threat of replacement. In a sense, it is the three of these
11 come together to provide the competitive constraint, so my view that basically National
12 Grid could not essentially set an average price that would exceed its costs, or what I call the
13 competitive level, is a consequence of the interaction of these three points, not of any
14 particular one of them.

15 Q I appreciate that is what you say, but just focusing on this particular point for the moment,
16 the one highlighted in the last sentence of para.78, I am sure you would accept that being
17 able to set prices above the competitive level is one instance of something that might
18 indicate dominance but it is not the only way in which dominance can be indicated – would
19 you agree? A. This is an interesting question. If one looks at almost all of the guidelines
20 and all of the practice of competition policy, dominance – I am not going to give the legal
21 definition, that is not my job – is almost always interpreted as essentially, does the firm in
22 question have the ability to set prices appreciably above the competitive level? It is thought
23 of in terms of price raising ability. So basically, in terms of how dominance is almost
24 always interpreted, that is my belief as to what actually happens in practice. I may be
25 reading more into this question than is there, but basically I think I am being asked, do I
26 believe that dominance entails anything beyond that. The answer is – I’m not giving a legal
27 judgment here – I have, personally, although I believe that what I’ve just said is a correct
28 description of how dominance works, some sympathy with views – let me give an example,
29 predatory pricing: suppose a firm basically does not have a dominant position, he engages
30 in pricing below avoidable cost, drives rivals out of the market and then acquires a
31 dominant position, then, in the USA under monopolisation standards, that would be caught.
32 I sometimes have a personal view that it’s slightly curious that we have a dominant standard
33 rather than a monopolisation standard. So basically if we had a different standard then other

1 things should be in, and whether we do, and I don't think we do, but that's not my
2 judgment.

3 Q Would you accept, and we can go to it, if necessary, that, for example, in the OFT guidance
4 it refers to matters such as being able to weaken existing competition, raising entry barriers,
5 slowing innovation. Those are the sorts of conduct that might be taken into account as
6 well? A. The answer is, basically impacts on the competitive process, whether this is
7 under dominance or other headings, are clearly important matters of competition policy. On
8 the other hand, the sub-text is there always that the weakening of competition is weakening
9 of competition that would be efficient on the merits, etc., so it is not purely that competitors
10 don't do as well as they would like to do. There has to be some reasonable and meaningful
11 sense into which they are people who, absent abusive conduct, would have been active on
12 the market and justifiably so.

13 Q I think what you are saying then, Dr. Williams, is that you are accepting that we are not
14 confined here to looking at whether the allegedly dominant undertaking can raise its prices
15 above the competitive level. We can look at it rather more broadly than that? A. There is
16 a legal question here on which I cannot pass judgment. As an economist, as I've just said, I
17 have views that these sort of questions might be better under a monopolisation standard. So
18 I can't pass a legal judgment, but I am happy to take questions as if there were, if you like, a
19 slightly subtler standard.

20 Q I am not asking you to pass a legal judgment, but simply to accept that in assessing this
21 from an economist's perspective it is also relevant to consider other features than simply
22 being able to raise the price above the competitive level? A. I would need to have
23 specific features put to me for me to comment whether or not those features were relevant,
24 but yes.

25 Q You do not take issue with the OFT guidance presumably? A. The OFT guidance is the
26 OFT guidance.

27 Q Do you take issue with it?

28 THE CHAIRMAN: Let us not stray too far from the point here. What is being put to you is that
29 there are a lot of abuse cases which have nothing to do with excessive pricing. There is all
30 sorts of conduct which a dominant firm engages in which can be seen as evidence of its
31 dominance because its customers would not have voluntarily entered into a contract in those
32 terms if they had had any choice about it and sometimes one looks at the conduct as an
33 indicator of dominance and that conduct may be a number of different things, it is not
34 necessarily excessive pricing? A. With that clarification I have to give my view, which is

1 suppose one did undertake this exercise in the present case, i.e. essentially we have abuse
2 which can be thought of as exploitative and exclusionary, so suppose one asked the
3 dominance question with an exclusionary hat on rather than an exploitative hat on – I think
4 that is as I understand your question. First of all, this is a screening process rather than, if
5 you like a full trial on the abuse, but if one were simply to do a screening process on the
6 matter at hand, most exclusion cases – basically you are thinking about some sort of pricing
7 below marginal cost and, in this case, the marginal cost is actually zero. So in just a very
8 high level this is not the sort of situation where actually inefficient exclusion is easily
9 possibly simply because marginal cost is zero. So if I were to go down that route and just in
10 a very cursory way do a quick screen of the sort that dominance is meant to be doing I
11 would conclude that this was not a promising avenue for an exclusionary abuse. But, as I
12 say, I don't go down that avenue simply because it is not what you normally do, but had I
13 gone down that avenue that is the view I would have reached.

14 MISS CARSS-FRISK: Yes, I think Dr. Williams, we will move on then to engage with your
15 basic thesis being about the ability to price above the competitor level. First, you see the
16 competitive level as being the P&M terms – that is right, is it not? A. I do not understand
17 all the details of how the P&M terms work, but it is my belief that the price under the P&M
18 is equal to the regulated price, so on that basis, yes.

19 Q Now, the regulated price in fact is the price cap set to prevent Grid from recovering
20 excessive profits – that is right, is it not? A. I imagine so, yes.

21 Q So it is a price cap and it by no means follows, does it, that because the cap is there saying:
22 “Grid, you can charge up to that level”, it by no means follows that that represents the
23 competitive level? A. No, on this I disagree. Again we have to go back to the
24 circumstances of this market and I think I need to explain why I think that the regulated
25 price is, in a sense, the relevant benchmark for the competitive price in this market. As we
26 have already discussed and are all aware, this is a market – there was a statutory monopoly
27 that was liberalised. Now, I have already argued that it is my belief that the most plausible
28 contractual forms in this market are that undertakings sign long run life of asset contracts,
29 and therefore one is in a situation so many years down the line, and we want to know what
30 would be the price list of those assets that had already been sunk had the market been
31 competitive at the time that they came into being.

32 THE CHAIRMAN: And that, as far as you are concerned, meant had there been payment
33 completion terms in the original arrangement? A. Had there been something from the
34 broad family of payment completion contracts at the time and moreover adding an

1 additional constraint the market was competitive at that point in time. So the thought
2 experiment that I go through to reach this is something like the following. There is one
3 moment in time when we have a reasonable approximation, subject to debates we heard
4 yesterday, as to what the capital base was, what a reasonable rate for turnover was, and
5 what the price coming out of that was. So basically I am a competition economist not a
6 regulatory economist, but I take the price that came out of that process at the regulation
7 point as being a reasonable approximation to a price that would have been a fair return on a
8 fair assessment of the capital base. I am not an expert on the debates we had yesterday.
9 So then imagine that that is so, which I think is reasonable, and then I ask: suppose, at the
10 moment of that regulatory settlement, there had been competition in the market, but where
11 that competition took – a thought experiment here, imagine the market was perfectly
12 contestable, I do not claim markets are contestable, but imagine it was and that would give
13 you an insight into how a fully competitive market would be, what would happen? Answer:
14 there would be competition for long run contracts at that moment in time and basically
15 somebody or other would win that contract at a price that basically reflected their costs. So
16 on the assumption that Ofgem had got its calculations right you would expect long term
17 contracts to be put in place at that moment in time at a price equal to the regulated price.
18 Now, there is a wrinkle, which is of course in such a price suppose the capital cost is 100
19 and let us suppose that the life of the meter – keep it really simple – is 10 years, then let us
20 take away from discounting that is £10 a year, but in fact there is an infinity of paths to
21 payment completion – it could be 10 in each year, or 20 for the first five years and then
22 nothing or zero for the first five years and then 20, etc. However, if you then add in an
23 additional constraint, which is that in the early part of this National Grid was not allowed to
24 set a price above the regulated price then that narrows you down from the entire family of
25 paths that add up to payment completion to effectively saying they have to straight line it or
26 at least straight line it up to the point where competition starts, and in that view the contract
27 that would be put on to the market would be one that would be payment completion of the
28 amount equal to the regulated price, but flat line because of the regulatory constraint.
29 Therefore, if now you fast forward four years and say: what would you observe in the
30 market at the moment of deregulation, what was the moment of deregulation? Had the
31 market been competitive from the moment of the regulatory settlement then basically that is
32 what you would find on the market – a series of payment completion contracts where the
33 price in that contract was straight-lined at the regulated price. So that is my reasoning

1 process as to why I believe that that is the appropriate benchmark for the competitive price
2 against which to judge various other things we are looking at in this case.

3 Q Does that assume that there nothing included in the price cap to compensate for the risk of
4 the asset being stranded? A. I have not thought deeply about this simply because, in a
5 sense, that was a debate of other people. I would point out the following, however, which is
6 that of course the test for whether or not one has got market power is whether you can raise
7 your prices appreciably compared to the competitive level. Now, it is my understanding
8 that the market facts are that the prices actually set by National Grid and the MSA where –
9 I do not know the exact numbers – some significant way below that level, therefore in a
10 sense my reasoning was simply that there was a sufficiently big gap there that even if there
11 was some moderation, some allowance made there then the test of whether it is appreciably
12 above would not be satisfied.

13 MISS CARSS-FRISK: So we make two assumptions. We assume that there was in place a long
14 term contract with payment completion dating back to the time of the supply of each legacy
15 meter, and we assume that the P&M terms then would be effectively the price – the
16 competitive price – included in that contract? A. I actually dated everything from this
17 magic moment of the regulatory review because that is the moment where all the
18 information was captured together, and the crucial thing here is the following, which is that
19 the regulated price on this view, one knows that the regulated price is the price cap and that
20 pricing can happen below that level, but the point is the way it is normally set under an RPI-
21 X type system is setting a price where you are going to get your cost of capital, given
22 existing cost conditions, things might develop, but the key point is it is the moment at that
23 time that you are setting the contract; it is basically the reasonable price at that point in time.
24 Therefore, arguments: “Ah, but the price of contracts is lower four years later” is not
25 relevant to the question of what the price of those contracts would have been three or four
26 years ago. So a crucial point there, which is yes, the market may have moved on is
27 undoubtedly the case, as we can see, but the longer contracts are offered into the market
28 now are more generous to customers than the ones that would have been offered three or
29 four years ago, but the relevant test – those contracts do not disappear, those contracts serve
30 life of contract at the original price even though new contracts are offered through time at
31 lower prices.

32 THE CHAIRMAN: Yes, because the company, which is subject to the price control is offered the
33 incentive that it can cut its cost and keep that benefit under the price cap that was set when
34 its costs were higher? A. That is a regulatory perspective on it, but the competition

1 perspective I had on it, which I think leads to the same conclusion is simply that in the
2 market where costs are falling through time, at any moment in time rental prices will be
3 falling for long run contracts and any snapshot moment in time there will be a whole range
4 of contracts of different vintages with different prices. Although we sort of rent them from
5 ourselves, you know, there are many of us who are renting PCs and laptops from ourselves
6 at prices we wish we had not committed to, but we rashly did, but we could get a better deal
7 were we to re-sign a contract today.

8 Q Dr. Williams, isn't the more meaningful assessment to consider to what extent Grid were
9 actually able to set the prices in the MSAs, compared to what might be seen as a
10 competitive level, or what is out there in the market at the time when the MSAs are made.
11 That is, after all, what we are concerned with in this case - whether there was abuse in
12 relation to the setting of those terms. A. When assessing the issue at question, you
13 obviously have to compare the prices actually set with some meaningful benchmark. I think
14 I have just given my full reasoning as to what I believe the reasonable benchmark is, and I
15 am not tempted to deviate from the view I have just given.

16 Q But you accept - and perhaps this, in a sense, is a matter of fact rather than anything else -
17 that MSA prices were actually higher than the CMO prices that were on offer in the market
18 at the time when the MSAs were made. A. I am aware that there is some factual debate
19 about this matter. I need to be clear here about my role. I am a professional anti-trust
20 economist and I am trying to give insights about this case. I am aware of the basic factual
21 matrix. I am also aware there has been some discussion on that. I am not involved in those
22 calibrations, and therefore cannot accept the proposition that's just been put to me.

23 Q The third feature that you have mentioned as demonstrating that Grid was not dominant is
24 the outside option for the customers of obtaining meters from the CMOs. A. Yes.

25 Q You deal with that in paras. 42 to 43 of your first report, starting at p.874. Now, you do
26 recognise - and I am looking particularly at your para. 43 of your first report that there are
27 logistical constraints on the pace at which Legacy meters could be replaced so that
28 replacement of the whole population could only occur over time. A. Yes, I am aware of
29 that.

30 Q That is a factor that clearly limits any countervailing buyer power, does it not? A. One
31 needs to be quite careful about what one is saying here. I have argued that because of
32 sunkness, etc. that National Grid is in a weak position because if its meters are ripped out,
33 it's in a weak bargaining position. To the extent that its meters can only be ripped out over
34 time, then clearly whilst its meters are being ripped out, it is able to get the regulated terms.

1 So, it is true that if it's meters are ripped out slowly, it's able to get the regulated price, but
2 actually the way to think about it is more the price it needs to offer to the other side, which
3 is basically that the other side can get the new CMO price from meters as they're replaced,
4 but, of course, has to rent the Legacy meters whilst they're being ripped out at the regulated
5 price. So, in a sense, the price they need to offer is a blend of these two. Provided any
6 meters are being ripped out, that blended price will always be below the regulated price, but
7 I absolutely accept that the slower that you rip those out, the closer the blended price will be
8 to the regulated price. But, as long as there is some ripping out, the blended price will still
9 always necessarily be below the regulated price.

10 Q I am not looking for the moment at your notion of blended price, but, Grid, I think you
11 would accept then on that basis, was a must-deal partner for the gas suppliers for some
12 considerable time. A. I think the proposition that is being put to me is that unless you rip
13 out all of the meters straightaway, then obviously there are National Grid meters that, if
14 you want to serve your customers, you're going to have to rent. Now, at this point one
15 needs to be careful about the phrase 'must-deal'. In the competition policy world, the word
16 'must-deal', you know, has a particular meaning here, which is that you have no choice but
17 to deal with that party. There are two, however, important aspects of the situation here,
18 which is that it's a one-on-one relationship. So, basically, yes, it's true that at no. 15
19 Arcadia Avenue that the gas company who has the contract with Mr. Smith who lives there
20 needs to rent that meter, if that's one of the meters they can't rip out. But, the other way, as
21 I explained yesterday, is that it's also true that British Gas is a must-deal for National Grid.
22 So, it's actually a two-way must-deal, not a one-way must-deal, and that takes it from, if
23 you like, a unilateral power to a bargaining set-up, as we described yesterday. So, that's
24 one important element. The second point is, of course, that if somebody is a must-deal
25 partner, the natural interpretation of that language is that they can charge you what they like
26 - or, at least extract all of the value from the relationship. But, of course, here you have got
27 the regulated price. So, it is a two-way must-deal but where one of the parties, National
28 Grid, has a constraint on the limit to which they can exploit that arrangement.

29 Q Another way of looking at it would be that Grid was able to use to its advantage its huge
30 installed Legacy base to transfer risk to the suppliers. Yes, it had to lower its rental prices
31 to some extent, but it was able to use that huge installed base that it had to transfer risk to
32 the suppliers and to get a long-term deal - that was extremely beneficial to it in those
33 circumstances - indicating very substantial power on its part. A. There are two elements
34 to the question which has just been posed to me. First of all, I think the phrase I heard was

1 that National Grid were able to use it to their advantage. Now, I have already said that if
2 their meter is to be ripped out straightaway, obviously they'd be in an extremely weak
3 position, and to the extent they can't be ripped out straightaway the weakness is not as bad
4 as it would be as if it were ripped out straightaway. So, when I hear the phrase 'used to
5 their advantage' I believe the correct reading of this would be 'used to lessen, but not
6 remove, their disadvantage'. Sorry, could you repeat the question? There was a second part
7 of the question.

8 Q I suggested to you that that involved an exercise of substantial market power by National
9 Grid -- or the ability to do so. A. Sorry. Could you repeat the original question please?
10 Is that possible?

11 Q The original question was that I was suggesting to you that there was an incumbent with a
12 very large asset base, able to use that to offer an across-the-board deal that involved transfer
13 of the risk to the suppliers, and then, as a result, a beneficial long-term contract for Grid.
14 The second part was that this involved the ability to exercise substantial market power.

15 A. Thank you. So, it was the transfer of risk phrase that I was referring to. I think this is a
16 mis-characterisation. Imagine a world where there was some risk out there - you know, that
17 a tornado will blow down your house -- That's an exogenous risk. If, currently, I bear that
18 risk and I say, "Can we pass this risk on to you" that is a transfer of risk and presumably
19 you would only let me transfer this risk from me to you if some money went with that risk.
20 Now, here, one needs to think about the risk in a very different way. The risk that one is
21 dealing with here is not some exogenous risk. It is actually the strategic risk that British
22 Gas, or the equivalent, would actually threaten to rip these things out, even though it's
23 inefficient in order to use that, as we have seen, as a bargaining lever to drive the price
24 down. As I think I have already indicated, essentially the basic P&M terms, although they
25 can't be objected to in terms of their price, are actually inefficient contractual structure
26 because they generate inappropriate replacement incentives. So, yes, there is an
27 inefficiency in-built into the P&M contract. I argue that the MSA contract corrects for the
28 in-built inefficiency in that contract, and that when you move from an inefficient contractual
29 form to an efficient contractual form, the efficiency deriving from that is, if you like, a gain
30 from trade. So, in this case what happened was not that a risk of Size X was transferred
31 from A to B, but that actually the risk which is a consequence of that inefficiency
32 evaporated. So there wasn't actually a transfer of the risk. There was, however, a transfer
33 of money. In the previous case I say you transfer the risk and you need to give
34 compensation for that. In this case the risk evaporated because of a move from an

1 inefficient to an efficient contractual form, but of course why were British Gas doing this?
2 Answer, because by threatening to go out they could threaten National Grid with stranding.
3 National Grid basically took that into account and made the payment over. So, no, there
4 was no transfer of risk; but, yes, that was used as a lever to extract the reduction in price
5 terms that we observed in the market.

6 Q Which assumes that there was the kind of inefficiency that you have referred to in the P&M
7 terms in the first place? A. As I have always said, the P&M terms, which do not have
8 appropriate payment completion mechanisms, although the price in them is obviously
9 unobjectionable, have this inbuilt inefficiency, yes.

10 Q You have made reference in your report also to the inability to guarantee the recovery of
11 sunk costs through the MSAs. What I would suggest to you is that the fact that you may be
12 unable to recover your sunk costs is not going to mean that you are not dominant, if, in fact,
13 you are able to set your prices above the relevant benchmark, the market benchmark?

14 A. Clearly, I think we have already agreed that the primary element of dominance is
15 whether or not the party can raise the price above whatever is the relevant competitive level.
16 I think we've disagreed about what that relevant competitive level is. Basically, my claim
17 is that you are dominant if you can't raise your price above the relevant competitive level.
18 However, in this case we're saying the relevant competitive level actually is the return on
19 the sunk costs in the regulatory asset base. So in this case, in fact, you are not dominant,
20 but that is a special feature of this particular case.

21 Q Would you accept that if an undertaking were able to set prices above the competitive level,
22 the fact that it might not recover its sunk costs would not indicate that it is not dominant. I
23 am sorry, there are a few double negatives there, but you see what I mean. A. I think I
24 see what you're getting at.

25 Q Leaving the debate as to where the competitive level is. A. I think this is really just a
26 definitional point, and, yes, I believe that dominance is ability to raise price above the
27 appropriately defined competitive level, and where that is compared to sunk costs would
28 then determine the answer to the question.

29 Q Moving on then to what you say about normal competition in your second report – it may
30 be worth just having that open and looking, first, at para.93 on p.3090, where you say that
31 you agree with certain statements by Professor Grout, as far as they go:

32 "In summary, given the sunk cost nature of Meter provision, I would indeed expect
33 to see payment arrangements that either involved up-front payment or some
34 contractual provision that guarantees recovery of the total of providing the Meter,

1 including the sunk costs of procurement and installation, irrespective of the period
2 of time the Meter is eventually used for.”

3 Just to pick up one point, would you agree that Professor Grout does not actually say that he
4 would expect to see provisions that guarantee full cost recovery in normal competition?

5 A. I can read through the paragraph above, and I’m guessing that doesn’t say that. May I
6 take it that he doesn’t?

7 Q You can, that is what I am suggesting. I am suggesting that he refers to a degree of
8 protection. Are you prepared to accept that? A. I am prepared to accept, on my quick
9 reading, that Professor Grout doesn’t say it, but I would say that in a market where one’s
10 making relationship specific sunk investments, if one does not have a strong expectation of
11 it, you either have a guarantee of it or one might only have an expectation of it, but where
12 there’s at least as much upside as downside, and normally only where the risks there
13 exogenous risks rather than endogenous strategic risks. Professor Grout says what Professor
14 Grout says.

15 Q In fact, perhaps an obvious point, but look at the CMO contracts in this case. You are not
16 going to get a guarantee of recovery of your costs in relation to everything. Take, for
17 example, faulty meters that, as you probably know, can be replaced free under the CMO
18 contracts? A. I have not studied the CMO contracts in extensive detail. If I can offer a
19 perspective as an economist, suppose one signs a contract for delivery, and the risk for
20 repairing faults stays with the vendor rather than with the customer, then if you know that
21 you’ve got a 10 per cent likely failure rate then it’s true that you get no guarantee on the
22 individual TV set, or whatever, but if the risk remains with the vendor you will make sure
23 that you mark that appropriately in the price at which you sell. So no guarantee to the
24 individual but if you’re retaining the risk there, it would be very unusual for them not to
25 factor that in.

26 Q Looking at risk generally, your ability to recover your costs, your ability to deal with risk, it
27 is all going to depend on the competitive conditions in the market, is it not? There is no
28 such thing as a guarantee in a competitive market? A. I think that’s right, yes.

29 Q Otherwise, as Professor Grout says, it would all be a very one-sided bet? A. I would need
30 to be shown the context of that particular comment.

31 Q It is para.72 of Professor Grout’s report, WS4, tab 9, p.2512. A. May I just read it,
32 please?

33 Q Yes, of course. A. Yes, I can comment on that paragraph. At the beginning he says that
34 you need to be confident that on average you will be able to cover your costs. So this says

1 suppose your costs are 100, then it is true that you will sometimes go into a market thinking
2 you might make 95, as long as there's an equal opposite probability that you'll make 105,
3 assuming here risk neutrality. So I accept that point. The point about the one sided bet, it's
4 true that if, in fact, you could always get 100, so you would never get 95, you'd always get
5 at least 100, but you'd sometimes get 105, it would be a one sided bet, though I would
6 expect that to be competed away. Of course, there is a huge difference between investment
7 in a regulated context and investment in a competitive context here. In the competitive
8 context there are the upsides and the downsides, you balance those risks. If, however, those
9 investments are made at a particular moment in time where there's a regulated context,
10 there's basically no upside. For example, to go back to my thought experiment, if there had
11 been some upside for British Gas in the period between their investment and deregulation
12 this type of analysis might have applied, but there wasn't.

13 THE CHAIRMAN: British Gas or National Grid? A. National Grid, sorry. If there had been
14 some upside between the moment of investment at the regulatory point and the moment of
15 deregulation, one could accept, okay, they'll make this investment because there's some
16 upside and they'll bear some of the downside of it. But again I also stress there's a crucial
17 difference between what I call exogenous risk this endogenous strategic risk. The
18 exogenous risk is hopefully swings and roundabouts and you hopefully win as many as you
19 lose, but making investments when you are putting yourself at the mercy of the customer in
20 a relationship specific sunk investment actually is the sort one way bet that I think Professor
21 Grout is talking about, but the other way round where you'd be insane to put yourself in that
22 position.

23 MISS CARSS-FRISK: Just picking up your point about the huge difference between the
24 regulated and the competitive context, and referring to whether there were any upsides,
25 surely there is a very great deal of upside to being a monopolist with, in effect, a guaranteed
26 revenue stream in that situation which was Grid's position? A. The upside I'm talking
27 about is upside compared to the normal competitive price, and basically one wouldn't
28 normally expect to get that in a regulated context.

29 Q Paragraph 94(d) of your second report, p.3091, this is under the heading "Payment
30 completion and efficient replacement incentives". A. Yes.

31 Q This is, as I understand it, really your central thesis about how the MSAs promote an
32 efficient market outcome, they provide for payment completion, prevents wastage of
33 working meters, and that is an efficient market outcome, roughly that? A. Roughly, but
34 one needs to be clear here. In essence because they provide efficient replacements in my

1 judgment, that means that there will not be wasteful duplication but the reason why I
2 believe that the payment completion family of contracts, of which the MSA is one, is
3 precisely because the economic price that they set is, in a sense, almost first best optimal.

4 Q So any contract that provides for payment completion generates efficient replacement
5 incentives and it would be misguided to ever call that “foreclosing”? That, as I understand
6 it, is what you are saying and I am referring particularly to para.106 here? A. Essentially,
7 focusing on the general point first of all, and then I will turn to the paragraph, if you have a
8 payment completion contract then the analogy here is that the incentives are as under
9 ownership. In fact, in a sense if you have a payment completion contract it almost is a
10 transfer of ownership and therefore basically, yes, I do believe that the family of payment
11 completion contracts are highly efficient. One never quite says “never”, but I am struggling
12 to see the circumstances in which the contract would not be efficient if it were a payment
13 completion contract. I have been invited to look at?

14 Q 106 of your report at p.3093? A. Can I just read it for a moment, please?

15 Q Yes.? A. (After a pause) Yes, sorry, is there a question.

16 Q Just linking that, before I ask the question, to para.108:

17 “108. Arguments about the precise form of supply contracts and whether they do
18 or do not foreclose entry must be viewed against the backdrop of a situation where
19 replacement of good working Meters is inherently inefficient ...”

20 So replacing a working meter is inherently inefficient - yes? A. No.

21 Q I thought that is what you said in para. 108? A. In 106 I make a claim about payment
22 completion. In 108 the point I say here:

23 “Arguments about the precise form of supply contracts and whether they do or do
24 not foreclose entry must be viewed against the backdrop of a situation where
25 replacement of good working Meters is inherently inefficient ...”

26 Now, that is not a logical claim, that is a contingent, factual claim. Obviously there are cost
27 functions of new meters, etc. functionalities of new meters under which replacement of
28 existing meters would be economically efficient. However, the point I am making here
29 goes as follows. It says that we are in a world where we have a legacy stock of meters. The
30 meters that are currently on offer to replace them are shinier but dumb meters which do not
31 have a materially additional functionality. So in that world, because the probable
32 functionality gain appears to be modest, but because there would be duplicated capital cost
33 were one to enter, then basically it is my conjecture – and I have heard various things in the
34 last days that other people may also form this view – that it is most likely (very likely

1 indeed) that it is not efficient to take a good working meter off the wall to replace it by
2 something else essentially the same.

3 So what I am saying here is obviously we are going to have to look at all the details of the
4 contracts, etc. to form a view about whether or not there is foreclosure, but if we are
5 focusing on what we have sometimes called “anti-competitive” foreclosure, in a sense
6 suppose one forms a view that some aspect of a contract has some incentive properties that
7 are not quite right, you then say so you would need to show that under that contract
8 replacement will not take place, but to show that there is anti-competitive foreclosure you
9 would have to say that were that contract absolutely perfect replacement would take place.
10 Since I am saying that, given the cost conditions, etc. of the market, I do not actually think
11 replacement would take place under any scenario then in fact if you think there is
12 foreclosure you have probably got it wrong; even if there is some minor distortion in the
13 contract it is very improbable that actually there is anti-competitive foreclosure when in fact
14 replacement is probably not the efficient thing to happen anyway.

15 Q Well looking at why it is not the efficient thing to happen, are you not assuming here that
16 there is going to be payment completion in the contract? That is the assumption you make
17 when you assess the efficiency or not and the incentives to replacement? A. I have seen
18 similar in the skeleton. What is my job here? There is a contract before us in the market
19 which is a payment completion contract. My job, as an economist here, is to help think about
20 the following question: does that payment completion MSA contract foreclose? Or at least
21 that is one of my questions. Now, that contract is a fact on the market. I have been asked:
22 am I assuming payment completion? There are two different ways I can be assuming things
23 here. One is am I assuming that that contract is a fact in the market? Yes, I am, that
24 contract is a fact in the market and I am taking it as a given and trying to analyse its effects.
25 There is a subtly different concept of assumption which is sort of creeping in here, which is:
26 Am I assuming that payment completion contract, though a fact on the market, is an
27 admissible contract which, in this context would basically mean that it does not violate
28 competition law. My point here is the following: In a certain sense at this stage of the
29 analysis one is, why? Because the question before us is: does this contract which, as a
30 matter of fact, exist, foreclose? At that point in a sense it is innocent. I then analyse its
31 effects. My claim is that when you analyse the effects of that contract you find that it does
32 not distort the placement incentives. So no, I am not assuming in the normative sense that it
33 is an admissible contract, I am starting from the assumption it is a fact and then, if my
34 analysis is correct, showing that it is an admissible contract.

1 Q Okay, I will put it slightly differently, your analysis as to incentives for replacement
2 proceeds on the basis of the payment completion contract being in place? A. It proceeds
3 on the basis that, as a matter of fact a payment completion contract, broadly speaking, is in
4 place.

5 Q Whether we call it an assumption or not, right. So you say on that basis, going back to
6 para.106, it would be misguided to brand a contract which provides, you say, socially
7 efficient incentives, as inconsistent with normal competition - yes? A. Yes.

8 Q So you are really saying regardless of how anti-competitive such a contract may be in the
9 sense of its effects on the competitive process, because it results in socially efficient
10 incentives, it is acceptable in competition law terms? A. I understand the question that is
11 being posed to me but believe it is fundamentally misguided. As I understand it, what is
12 being put to me is – I am claiming that when you analyse the payment completion contract
13 it leads to non-foreclosing incentives, so in that sense where the question is: is there
14 foreclosure? This is, on my view, not an anti-competitive contract.

15 Now, the question I got was: aren't you assuming that this thing is okay, no matter how
16 anti-competitive it is?

17 THE CHAIRMAN: Is this the point, that you accept, I think, that if there is replacement of
18 meters, incentivised by the fact that the existing contract price is higher than the CMOs'
19 price, that should be avoided or at least it is not inefficient to prevent that from happening if
20 the reason why the price is higher is because it includes payment completion? A. No, no,
21 it is slightly different from that. I make the claim that if you have a payment completion
22 contract it generates appropriate incentives - efficient incentives. Obviously we can debate
23 that, but let's assume that's correct. I am then saying that suppose you have that contract in
24 place, and then suppose that when that contract is imposed upon the market some entrants to
25 that market do not get to make sales that they would perhaps have hoped to have made.
26 Okay? My claim is that any loss of hoped-for business that any entrant suffers, in a world
27 where the incentives for replacement are at the efficient level, is very for the entrant but is
28 not in any economic meaningful sense anti-competitive foreclosure. That is actually the
29 outcome that the market wants.

30 MISS CARSS-FRISK: If the rentals were set at the level that is in the Legacy MSA, those rentals
31 are still higher than are available from the CMOs. So, if you had the Legacy MSA rental
32 rates and you had no PRCs, say, there would still be an incentive on the gas supplier to take
33 out the existing meters and replace them with the CMOs meters because those are cheaper.
34 Now, I thought what you were saying was that it is not foreclosure to add in a contract term

1 which prevents that from happening because to remove that incentive that is generated by
2 the difference between the MSA rentals and the CMO rentals -- to remove that by your
3 other contractual is not foreclosure because that difference represents the payment
4 completion by National Grid. A. No. There are elements of that in what I'm saying, but
5 I think it's probably best if I try and re-put to you what I am saying. I'm saying that under a
6 payment completion contract, the incentives are, absent externalities, absolutely efficient
7 incentives, i.e. basically under that contract entry may or may not occur, but if it occurs it
8 will occur because the entrant is genuinely able to compete on the merits and offer better.
9 So, if those incentives exist - which I claim they do if it's a payment completion contract -
10 entry will occur precisely when it should occur, and will never occur when it shouldn't
11 occur from the standpoint of an economist of an efficient outcome of the market.
12 Now, P&M contracts are inefficient. Why? Because they do not provide for payment
13 completion, they generate excess incentives. My characterisation - if I may offer my own
14 characterisation of what this case is about - is that one had a set of contracts (the P&M)
15 where although the price was inoffensive, the incentives for replacement were artificially
16 skewed towards inefficient replacement. We heard various debates about various people
17 believing that in addition to myself. What happened was that the market saw that these
18 inefficient contracts were in place; the parties negotiated a better contract that removed the
19 inefficiency, albeit it passing much of the benefit to British Gas; and moved us from a world
20 where there were excess inefficient replacement incentives to perfect incentives.
21 Now, in that process any entrant who was looking at the P&M-type contracts and thinking,
22 "How much entry could I get under the P&M contracts?" would, quite naturally, be hoping
23 for quite a bit of entry. It is true that once the market found a way from the inefficient
24 contract to the efficient contract, that that hoped-for entry opportunity disappeared - and
25 rightly so. One can understand why they are frustrated here. But, basically, that is what
26 happened - they had inefficient excess incentives and the market found a way to correct
27 those and at that point the incentives essentially were such that that entry was not going to
28 happen.

29 Q So, coming back then to the point you make in para. 106, you are saying, are you not, that in
30 this market with perfect incentives that you postulate, even though it may have the effects of
31 denying entry to would-be competitors or restricting competition by those who are in the
32 market at all, you are saying that that is effectively irrelevant for competition purposes
33 provided that you have what you call perfect incentives in place. A. I think I am saying
34 that. I think that, in a sense, there is a view that I think may be underpinning what I am

1 hearing here - that more entry is better than less entry. Now, my view is that one has to
2 have a standard. I believe that efficient replacement incentives is the only standard I can
3 think of as a sensible standard. If one says that it is foreclosing - anti-competitively
4 foreclosing - in a meaningful competition policy sense of entry that does not occur on that
5 standard -- I will strike that sentence - too many negatives there. If you have that standard,
6 there will be entry where efficient. If it is argued that to prevent inefficient entry in this
7 way is an anti-competitive abuse (a) as an economist I find that very strange, but I would
8 also point out the following: which is that I don't know where you stop. That is basically,
9 suppose you should allow one more meter to be replaced -- you should change the contract
10 so that one more meter would be replaced in the efficient level. Okay? Well, what about
11 that? That, on that standard, would also be an abuse because, of course, you could have a
12 contract which allowed two more meters than efficient to be replaced. But, that would be
13 no good because then, of course, that contract too would be anti-competitive because there
14 would be another one that would allow three to be replaced. At that point, essentially, you
15 just say that you have to allow everything to be ripped out. If that is the standard you adopt,
16 in addition to it being totally inconsistent with everything economists understand about, in a
17 sense, efficient outcomes, it is also not an implemental test simply because there is
18 absolutely nowhere where it stops until, well, as far as I can see, a firm which is dominant
19 and effectively has to cease to exist.

20 Q Dr. Williams, just going back to the starting point of this about efficient incentives and the
21 need for payment completion, that is really, ultimately, in order to prevent replacement of a
22 working asset -- of a working meter. That is the starting point of the analysis, is it not?

23 A. It is not to protect at all costs the working meter, but to protect a working meter where
24 there is no superior meter which would be more efficient to replace it. Clearly, if a meter is
25 not working it does not really apply. So, it is working meters that offer better value than
26 any plausible replacement, including the capital cost of the duplication, yes.

27 Q On this analysis, are you not effectively ignoring the economic efficiency of competitors
28 coming in, offering cheaper prices. Why is cheapness not a relevant consideration here?

29 A. I am trying to unpack the question. I think there are two elements there. Cheapness has
30 to take into account not just the marginal cost, but also the fixed cost and the basic reason
31 why entry is not possible here is that the entrants actually have to incur a duplicated capital
32 cost and the incumbent does not because it is already sunk. So, the first point, I think, is
33 already dealt with.

1 But, there is a second sub-text to this question which I also read in some of the pleadings.
2 This sub-text - and I hope I am not falsely characterising it - says something like the
3 following: that there are dynamic benefits of competition. That may be true. So, the sort of
4 story here we have is something like, "Oh, there may be learning by doing effects,
5 endogenous technical change, etc. If only you allow people into the market, then, in a
6 sense, costs will fall -- production costs, etc. will fall faster than they otherwise would". I
7 think I detect that sub-text in some of the later skeleton.

8 Now, what would be my reply to that? Well, (1) it's not documented, but that's not my
9 fundamental problem with it. My fundamental problem with it is just, "So what?"

10 Essentially, this is saying, "Suppose there is a positive externality, taking into account all of
11 these factors of additional entry". Of course, we know from our papers that actually there
12 can often be excess entry, but let's ignore that. So, let us suppose that our positive
13 externality is on dynamics of excess entry. Now, when I say that these incentives set the
14 efficient replacement incentives, of course, I did have a footnote where I say, you know, as
15 one always must here, "Assuming no externalities". So, now let us remove that
16 assumption and assume that there are positive externalities of entry which I do not think has
17 been demonstrated, but I am going to assume it..

18 THE CHAIRMAN: That must be the basis on which it was decided that this sector should
19 become open to competition rather than be a regulated sector. A. I am assuming that, in a
20 sense, one is in a discovery process to find out whether they are there. Then I come back to
21 competition policy versus regulation. If there are dynamics in the market, etc, in particular
22 if there are positive externalities in the market of this nature, then basically what do you do
23 about it? Well, the first thing you do as a matter of public policy is you appoint regulators
24 or governments to subsidise those positive externalities. Secondly, even if you think they're
25 here, there may be other participants, like makers of smart meters or the people like the gas
26 companies who would be able to get rid of all their meter reading staff who have strong
27 incentives to internalise them. The fundamental point is the following: suppose there is a
28 positive externality in this market that is not internalised in the position that I've written
29 down, are we saying it is foreclosure or any form of market abuse for a firm to not
30 internalise positive externalities. If there are positive externalities there will be a social
31 deficiency. If you can find some market or plan a way to solve them, great; but if we can't
32 to say that it is incumbent upon the dominant firm to solve all positive externalities or
33 negative externalities in the industry seems to me to be - and this is almost a judgment on
34 the philosophy of competition policy - a serious extension of what competition policy is,

1 and re-interpreting competition policy as implementing the outcomes of the
2 regulatory/social planner.

3 MISS CARSS-FRISK: Could it not be something much more simple than that, which is that an
4 undertaking in the position of Grid must be careful not to enter into foreclosing contracts
5 that, on your view, would be socially efficient, but may, in fact, prevent that which
6 competition law is surely all about, which is to achieve efficiency through a process of
7 competition? A. No, I disagree strongly with what I've just heard. There are various
8 elements of it. The first element is that part of the special responsibility with dominant
9 firms to internalise externalities – I'm not a lawyer, but that seems to me not to be outside
10 the scope of competition policy. The other point is this, actually it's not even foreclosing.
11 Suppose you have a market where – let's take a simple example – there is a learning by
12 doing effect. Basically when you go into a market and you gain experience in that market,
13 you become more efficient. What is the normal market pricing mechanism that occurs
14 when there is a learning by doing process? Answer, the firm that benefits from the learning
15 by doing actually discounts its pricing. In many cases it's actually willing to make a loss in
16 the early period in order to get down the learning curve and then will reap the benefits later.
17 In fact, it's not even foreclosing because if these effects are present the parties who will
18 benefit from them actually will be willing to lower their prices even more to get into the
19 market. So, one, I don't believe its incumbent upon a dominant firm to internalise these;
20 but I even dispute that it is foreclosing once you realise how, in the presence of those
21 dynamic effects, the rational strategy of the firm that might benefit from them will actually
22 change. So I dispute it's even foreclosing.

23 Q I see. Looking at your straight sale analogy, which you refer to in para.102 of your second
24 report in particular, p.3092, a benchmark case. A. This is also in my annex from 2006 as
25 well, but yes, 102.

26 Q I am sure it is, yes:

27 "To see why payment completion ensures efficient replacement incentives,
28 consider the benchmark case of a payment completion contract, a straight sale."

29 At para.105, as I understand you, you are suggesting that a long term rental contract with
30 payment completion would be analogous? A. Yes.

31 Q Would you accept that there are some differences between a straight sale and a rental. For a
32 start, an obvious one perhaps under a straight sale the purchaser gets all the benefit of the
33 asset which does not actually occur in relation to rental? A. It is clearly the case that
34 there some legal differences between straight sale, long term lease. People talk about

1 buying a house in Chelsea, but in fact they're just buying a long lease and it's actually the
2 Duke of Westminster who ultimately owns it, etc. So I agree there will be minor
3 differences between these. When I say look at straight sale as the analogy here, I am talking
4 about the fundamental incentives for replacement under the payment completion contract
5 and a situation where you own the asset. I am not disputing there will be some minor
6 differences between them, but in terms of the fundamental incentive properties my
7 argument is that the fundamental incentive properties for payment completion contracts,
8 such as the MSA, is almost identical to that under ownership. I mention this simply
9 because, to the extent that anybody is still trying to understand why a payment completion
10 contract sets correct incentives, once one recognises the almost perfect analogy to
11 ownership, it is much easier to grasp that my incentives to upgrade my television are not in
12 any way distorted if I own my television.

13 Q You say "almost identical to ownership". Looking at another difference, I would suggest to
14 you a difference, in a rental relationship of course it is an ongoing relationship where your
15 replacement incentives may be influenced by that ongoing relationship – for example, by,
16 say, increased or indeed decreased service provisions in connection with the rental? A. I
17 regard this as just a minor detail around the outside that does not affect the fundamental
18 point that the replacement incentives under an MSA and under ownership are essentially the
19 same.

20 THE CHAIRMAN: Another difference though, with the rental the payments continue after,
21 sometimes long after, payment completion has happened? A. It's true that sometimes if
22 you buy something on hire purchase you end up paying ----

23 Q I am not talking about hire purchase, I am talking about in these contracts. We have seen
24 that the gas meters stay on the wall for more than 18 years in many circumstances, and
25 rental continues to be paid. A. That is where I would come back actually to a point that
26 was raised by Professor Grout, that one has an expectation on average of recovery in these
27 things. Obviously meter life is an uncertain science and some live longer than others. In a
28 sense, some you'll get more, some you'll get less. The relevant question therefore as to
29 whether there has been over-recovery is to look at the portfolio as a whole. It's my
30 understanding that it's not alleged that there's over-recovery on the portfolio as a whole.
31 Even if, for example, one particularly long-live meter might have been a good investment,
32 there were others that weren't. So basically I believe that the question of over-recovery has
33 to be looked at on a portfolio basis.

1 MISS CARSS-FRISK: Another relevant difference, I would suggest, between ownership and
2 rental is that in relation to rental you cannot assume, can you, that the rental is actually fixed
3 at the time of supply regardless of competitive considerations as they may develop during
4 the continuation of that relationship? A. I think, if you have a rental contract, for goods
5 where there is a relationship specific sunk investment that actually the rental will be fixed.
6 In the case of rental of goods where there is a much more fluid market in both directions,
7 then one may well find that you just rent it at the current spot price, but that is in a wholly
8 different factual matrix from where there is relationship specific sunk investment.

9 Q So there are some differences, you would accept. Coming back to ---- A. Excuse me,
10 you said there were some differences that I would accept. I think I've said that I accept
11 there may be some legal differences, but I do not accept there are differences that affect my
12 fundamental economic point.

13 Q All right, so be it. Looking at your notion of efficiency again, of course payment
14 completion would not be the only way of avoiding what you have described as an
15 inefficient outcome, i.e. replacement of working meters. You could avoid that by
16 competing on price, could you not, if that is going with the idea that it is inefficient to
17 replace a working meter? A. Right. First of all, a couple of things here. One, you've got
18 the vice that this is a different world, but I'll describe this now. Essentially, we talk about
19 payment completion here and there seems to be a misunderstanding that this is an objective
20 of National Grid. National Grid's objective, I would guess is profit maximisation subject to
21 non-breach of competition law, and I believe I have even seen documents to suggest that
22 that was the aim. So setting of efficient replacement incentives is not the objective of
23 National Grid, it is profit maximisation subject to breach of competition law.

24 So if one then were efficient replacement incentives then it is true that if you have payment
25 completion there is a whole family of payment completion contracts. All that says is that if
26 the rentals add up to 100 the PRC is 100, and if the rentals add up to £31, the PRC is £31.
27 There is a whole family of payment completion contracts. The view that is being put to me
28 here says – and there are some maths that shows the inequality that there is a price to which
29 you could lower the spot price such that replacement would not take place and you would
30 still have efficient replacement. I do not disagree with that. That is really just another
31 version of saying there is a family of payment completion contracts. But there are two
32 fundamental points that one now needs to make.

33 First, for any price reduction on a spot contract that is put to me, to say “Actually, couldn't
34 you just do that?” The first thing you need to do is to check whether that is actually profit

1 maximising, and the answer is it is almost certainly not, because given the way that rentals
2 have come down, a better strategy from the point of view of profit maximisation is simply
3 let them rip the meters out and take the regulated price. Obviously, you also need to do a
4 quick check that that does not breach competition law but it is setting a price, a regulatory
5 price and clearly does not. The first thing is that the alternative that is being put is in fact
6 not profit maximising and there is a superior strategy from the point of view of National
7 Grid that is (a) profit maximising; and (b) in my view competition policy compliant. So
8 first, that is not a relevant scenario to compare it with, but now the second fundamental
9 point. Let us imagine that in fact the price is put to me that would, in fact, generate efficient
10 replacement incentives, would in fact be profit maximising – well they might have done it,
11 but let's suppose notwithstanding that, that exists, what are we saying?

12 Consider the set of strategies available to National Grid, the complete set of commercial
13 strategies in this arena, and then say: what are they allowed to do? Well, basically they
14 must not breach competition law and crudely characterising it we can say there are the
15 exploitative abuses and there are the foreclosure or exclusionary abuses. So clearly, they
16 must not adopt any of the strategies that generate exploitative returns. Also, they must not
17 have anything that is foreclosing, and obviously I have argued that the MSA is not in that
18 set either.

19 Then you are left with the set of competitive strategies that are not excessive, which I
20 believe is not alleged, and on my analysis the ones that are not foreclosing which again I am
21 saying is not the case for the MSA. Then you have everything else.

22 At that point we are saying in that set there is the strategy adopted by National Grid, which
23 does not, on my analysis breach these conditions and then, although I do not think it is
24 relevant, there is the strategy that is being put to me by counsel. At that point what are we
25 saying? My interpretation says that under regulation, the regulator can go – in fact, they can
26 go anywhere they want, probably not into the breach of competition law section – and
27 choose any point they like in that space, that is what regulation is.

28 What is competition policy? Competition policy says you have the strategy space, you must
29 not exploitatively abuse, you must not exclusionary abuse, but apart from that you can
30 choose any strategy you like in the remaining set. So even if it were, which I deny, that
31 there are two points in this set, the National Grid strategy, and the one that has just been put
32 to me, which I do not think is in this set because it is not profit maximising, I believe it is a
33 mischaracterisation of competition policy to say that one has not chosen the one that is

1 preferred by the regulator is an abuse of dominance, even if it would be entirely free for the
2 regulator, under his regulatory powers to impose that outcome.

3 Q Well my question was simply whether it would not be possible to avoid what you would
4 characterise as inefficient replacement by a policy of lowering price, and you started off by
5 saying “yes” to that and that was my question? A. If I may clarify ----

6 Q I think you have done? A. Theoretically “yes”, but it may or may not be profit
7 maximising. I believe it is not, but even then I claim that would not make it an abuse.

8 Q It is not profit maximising because there is the alternative of the P&M contract and it is less
9 profitable than that? A. Yes, in a world where in a sense the price has come down, say,
10 30 per cent and they can only rip you out – we can haggle about whether it is five years,
11 eight years, or whatever – they can only rip you out at that pace, basically in every year you
12 are only losing 10 or 12 per cent of your base, therefore you may as well take the regulated
13 price on that rather than cut your price all the way down – profit maximising, totally
14 competition policy compliant.

15 Q Still on your thesis about payment completion ensuring the efficient outcome, it would seem
16 to follow, would it not, from that thesis, that no matter how inefficiently the costs of the
17 relevant undertaking have been incurred, so long as all that happens is that you get payment
18 completion in relation to those costs. There is nothing objectionable about such an
19 arrangement, it still achieves efficiency, does it, on your view? A. There are two
20 elements there. First, unless I am misunderstanding you, it seems to be repeating a point
21 that the payment completion is of costs incurred, whereas payment completion when I use
22 it, is always about payment completion of the agreed rentals. That is the first observation.
23 The second observation is the following: if, in fact, the National Grid had incurred costs
24 inefficiently then there may be a very interesting and separate inquiry we could have into
25 that, etc. My understanding is that that is not what is alleged in this case, but it has nothing
26 to do with the foreclosure issues in this case.

27 Q I see. Would it follow from your thesis that no matter how long term a contract that sought
28 to ensure payment completion in the way you have described, and no matter then how
29 exclusionary its effects, it would still be efficient and therefore not a abusive in your view?
30 A. I should point out that the question assumed that it was exclusionary, which is a
31 conclusion to which I have argued and denied, so just note that first in the question. Then
32 secondly, the real substance of a question was saying: “What if this contract is very long,
33 and the answer is: actually, if the incentives it sets at any moment in time are not

1 foreclosing or exclusionary then actually, from a point of view of foreclosure and exclusion
2 it does not matter how long it is, ownership lasts until the thing drops dead.

3 Now, of course, if in fact one has a very long run contract, etc, if you had a 100 year
4 contract at a rental that was a 20 year rental you might well, under that contract, way over
5 recover, at which point of course there would be an excessive pricing issue, but I believe
6 that is not the issue before us.

7 Q Yes, thank you. Moving on to something slightly different in your second report, paras 114
8 to 115, p.3094. You say:

9 “114. First, as I show in section 3.2, there has in fact been competitive pressure
10 on National Grid’s rental charges from the threat of replacing Meters. That
11 pressure manifests itself both in gas suppliers switching volumes to CMOs and
12 National Grid reducing rental prices below the regulated level across the board,
13 responding to the threat of Meter replacement. Thus the market exhibits both
14 actual replacement and the disciplines of threatened replacement on pricing.”

15 115. Accordingly, since the Legacy MSA contracts to which Prof. Grout objects
16 have the same benefit – competitive pressure on rentals – that he sets out as a
17 benefit of age-related contracts, his argument as to why the Legacy MSAs do not
18 constitute normal competition does not stand.

19 So your starting point here, as I understand it, is you say there has been some competitive
20 pressure on Grid to lower its rentals in the MSAs, is that right? That seems to be what you
21 are saying in para. 114? A. That is what I say and what I believe to be the case.

22 Q You then say therefore this provided the same benefits as the age-related approach that
23 Professor Grout refers to (para.115)? A. No, can I clarify here. My fundamental
24 argument as to why these contracts are not foreclosing are the arguments I have rehearsed at
25 some length. All I am saying here is the following. Professor Grout has a view that age-
26 related contracts would be better in a meaningful way, etc, and in the paragraph I quote he
27 says that they allow them to benefit from competition through appointment of CMOs,
28 competitive pressure on rental charges, etc. He is putting that forward as a benefit. As I say,
29 my fundamental defence of why I believe the MSA contract is not anti-competitive is what
30 I’ve given. I am here merely observing in a responding way that even if one ignores
31 everything I’ve said previously and believes the argument of Professor Grout that these
32 other age-related contracts are better, and pointing out that some of the benefits that he
33 attributes to his view are in any case present from the MSA contracts and therefore, in a
34 sense he is over-accounting for the benefits of his view compared to the MSA contracts.

1 THE CHAIRMAN: There is another way of saying that: you would maintain that the MSA
2 contracts were not foreclosing, even if they had allowed for payment completion up to the
3 total net present value of the rental. We know that they have not achieved that. A. No.
4 My point about payment completion contracts not being foreclosing is payment completion
5 at any level of rental that has been agreed. Now, this is a fundamental and slightly subtle
6 point. Let me take an absurd example. Suppose that the rental contract agreed was £1
7 billion for one meter. Okay? That would clearly be excessive. But, if in fact you had
8 agreed to rent a meter for £1 billion and then there was a payment completion term for it --
9 This is, you know, what we have in the annex. Those numbers would actually cancel out.
10 So, the result that there is no distortion simply follows from the fact that the PRC does not
11 happen to equal the rentals - it is deliberately set to absolutely equal them. It's as if you've
12 already bought it in a sense. They cancel out. That cancelling out - and there may be a
13 mathematical exception here for some sort of strange number - will happen whatever the
14 level of those rentals. Of course, if the rentals were way high, there'd be an excessive
15 pricing issue. But, they cancel out, whatever.
16 So, the argument that it is not foreclosing is completely divorced from whether or not the
17 level of rental extracted in the MSA contracts is below, at, or above the regulated level. If
18 we're above the regulated level, some of my earlier claims about not being able to raise
19 prices above the competitive level would fall, at which point the argument that there is not
20 dominance would fail. But, there would still not actually be a foreclosing effect ... There
21 would be an excessive pricing issue potentially, but there would not be a foreclosure.
22 Fundamental insight there of the cancelling out.

23 MISS CARSS-FRISK: Dr. Williams, just going back to my question on paras. 114 and 115, and
24 looking again at what you say in para. 115 about the MSA contracts having the same benefit
25 of competitive pressure on rentals as he sets out as the benefit of age-related contracts, are
26 you not there ignoring his fundamental point about the age-related approach providing
27 greater incentives for suppliers to switch to the CMOs than under the MSAs, and therefore
28 providing a greater constraint on pricing? A. Right. There is an important point here. I
29 am going to say something, and then immediately add a caveat. (After a pause): The
30 analysis I have provided shows that the MSA does not distort incentives, but, in a sense, one
31 has done that at a level of an individual meter. There is a question as to whether this, if you
32 like, aggregates up into the entire contract. Now, there is an intuition that -- Let me give an
33 example. Imagine that meters are, on average, ten years old, and that the rental is £5 per
34 year. Then the PRC should be £50. But, let's imagine that, in fact, all meters are either

1 five years old or fifteen years old. So, obviously, one might think that on a meter that is five
2 years old, there is fifteen years to go and so you should have a £75 PRC, and, the other way
3 round, a £25 PRC. So, you've got this situation where on the old meter you should have a
4 low PRC and on the young meter have a high PRC. But, because it is set at £50 it is too
5 high for the young -- The £50 PRC is too high for the old meter - because that should be
6 £25.

7 Now, the caveat I must insert at this point is that what I am telling you is my understanding
8 of how the contracts work, and I am doing this simply so as to alert you to this issue. But,
9 the evidence supporting that view is due to the analysis of my colleague, Mr. Mathew, who
10 you have the opportunity to examine later. So, I am not saying that this is true. I believe
11 this to be true from what I have heard, but I am not a direct witness on this.

12 Essentially, the way it works on my understanding is that if you rip out a meter of whatever
13 age, then what it does, if you pay a £50 PRC and the rentals are £5 per year, what that buys
14 you out of, if you like, is ten meter rental years.

15 MISS CARSS-FRISK: Dr. Williams, I am sorry, but you are giving very long answers and I am
16 not sure that this is really directed to my question which was whether you are not, in your
17 para. 115, ignoring the greater incentives for replacement that would arise under the age-
18 related contract. A. The point that was put to me was that I was ignoring the greater
19 incentives. I apologise that this is a complicated matter, but what I was in the process of
20 explaining is that the supposedly greater incentives that I was ignoring are not in fact
21 present. So, the line I was about to come to says that although it looks as if you sort of
22 might have overpaid, when you pay a £50 PRC you buy yourself out of ten meter rental
23 years. The entire glidepath shifts, and so in fact you have not got the bad incentive that is
24 being suggested here. But, as I say, I make that point because it's in reply to a question put
25 to me. But, ascertaining whether or not the glidepath shifts is Mr. Matthew's territory.

26 THE CHAIRMAN: We understand your caveat. A. I apologise.

27 MISS CARSS-FRISK: Can I put my question slightly differently on this? I understand that this
28 is between Mr. Matthew and Mr. Keyworth rather than between you and Professor Grout,
29 but assuming that there were in fact a greater incentive for replacement under the age-
30 related approach, then it would not be right to characterise the MSA as having exactly the
31 same benefit in terms of competitive pressure, which is what I understand you claim in para.
32 115. A. I want to be very careful in answering this question. I have claimed - and I
33 believe it generalises - that the MSA does in fact set those incentives. The question that's
34 being put to me is: If I am wrong and it doesn't set those incentives, and the incentives are

1 in fact ones that mean there is a distortion to replacement, do I agree that basically there's a
2 problem? The answer is that although I don't believe that arises, yes, in that circumstance
3 there would be a problem. In a sense, if our analysis is wrong, then, yes, our analysis is
4 wrong and there would be a problem.

5 Q Thank you. Paragraph 117 of your report.

6 THE CHAIRMAN: Can I just pause there. Mr. Williams, you have been going now for
7 something over an hour and a half. I know it is difficult to say, Miss Carss-Frisk, but
8 roughly how much longer do you have with this witness?

9 MISS CARSS-FRISK: Perhaps another twenty minutes. A. That's okay. I'm happy.

10 THE CHAIRMAN: We will continue then.

11 MISS CARSS-FRISK: Paragraph 117 of your report.

12 THE CHAIRMAN: Sorry. I think we will in fact take a five minute break at this point. Is that
13 convenient?

14 MISS CARSS-FRISK: That is fine.

15 (Short break)

16 MISS CARSS-FRISK: Dr. Williams, para. 117, please, of your second report, please, at p.3095.

17 You say, finally, concerns that,

18 "A firm can distort competition in the first instance by exclusionary conduct are
19 ultimately driven by the ability to raise prices later, after competition has been
20 eliminated".

21 Then you make the point that,

22 "The MSAs have a fixed price, and you say that this effectively prevents any
23 recoupment or future exercise of market power on these meters".

24 Perhaps a very obvious point, but even if that is so, of course, it does not stop the MSA
25 from being abusive to the extent that it may create a situation where Grid is able to exploit
26 its power in the future in relation to other meters than these ones. A. The point I'm
27 making in para. 117 is the following: the primary reasons I've given for why the contracts
28 are not exclusionary are the things that we have been discussing. However, this paragraph
29 is really almost a footnote. In many theories of exclusionary abuse - predatory pricing is an
30 obvious example - the entrant comes into the market, you have a skirmish, you drive them
31 out of the market, you get rid of them, and then you get payback. There is the obvious
32 interesting question about whether or not ... is or is not part of the test, etc. The point I am
33 making here is simply the following: this is just an add-on to everything else. It says,
34 "These are long-term contracts" The price at which all of these meters have been sold are

1 contracted for the remainder of life. So, any essence in which, for example, if it's perceived
2 one has distorted the competitive process, there is not going to be a payback of the
3 conventional sort that one sees in an exclusionary case (or even in extremis not for eighteen
4 years or whatever). So in a sense this is not a major plank of my argument, it's everything
5 that's come before. This is just if you have any residual concerns, this doesn't look the sort
6 of situation where this sort of exclusionary abuse has obvious plausibility.

7 Q So not a payback in relation to these meters, but that does not stop the potential payback
8 once everyone has been driven out in relation to other meters?

9 THE CHAIRMAN: You mean other than gas meters, or ----

10 MISS CARSS-FRISK: No, other than the meters that are the subject of this particular contract,
11 which, as I understand it, is what Dr. Williams is actually referring to here. A. I don't
12 believe the contract is exclusionary. I believe that when new meters come up for grabs in
13 the market when there is an opportunity, e.g. for replacement, then all of the competitive
14 processes that one sees in events are likely to occur. I'm not making a huge point here. I
15 don't admit that it's the hint of the suggestion, but I'm not making a huge point here. This
16 is just a footnote saying that there isn't an obvious story here to do with "drive them out and
17 raise the price". That's all I'm saying.

18 Q For the final time, Dr. Williams, it is, however, a footnote that is confined to the particular
19 meters that are the subject of the MSAs? That appears to be what you are saying in the last
20 sentence of para.117? A. Yes.

21 Q Thank you. A. To the extent that in the price it's for those meters.

22 Q Very briefly, looking at what you say in section 4.4 of your report about age-relatedness,
23 looking particularly at para.125, you say:

24 "By and large one might find it preferable that old rather than new meters should
25 be replaced first, but suppose that this has not occurred, this might be a sub-
26 optimal resource allocation but that does not constitute an obvious abuse of
27 dominance, specifically the abuse alleged is that of foreclosure, but Professor
28 Grout does not in any way show the link between poor estates management
29 incentives and foreclosure."

30 I would suggest to you that what he is showing is, in fact, a link between the foreclosing
31 effect of the MSAs, as he sees them, and the greater incentives for replacement that you get
32 under the age related approach. So he does, in fact, have the link that you claim he does
33 not? A. My reply to that goes back to some remarks I made earlier about whether or not
34 the lack of age-relatedness of the contract does actually, once you understand the shift in the

1 glide path, lead to inefficient meter incentives. So basically my comment that, as far as I
2 can see, Professor Grout has not established that that view is wrong. The point I am making
3 here is separate. It says, although, if that analysis is right, there have not been in aggregate
4 inefficient replacement incentives, then if – and I personally believe this is a very complex
5 matter as to what are the right meters to rip out, etc, we heard some of that yesterday – at
6 the end of the day the Tribunal is not satisfied that the way in which policy meters, etc, are
7 selected is a first best optimal estate management process, I am saying that I believe that
8 that is a separate question from whether or not opportunities to enter the market have been
9 foreclosed. You might have the wrong meters there. That’s for efficiency, etc, it might be
10 something you might want to look at, but it is not related to the foreclosure thing, that’s all I
11 am saying here.

12 Q Thank you very much, Dr. Williams.

13 THE CHAIRMAN: Does either of the interveners have any questions?

14 MR. VAJDA: I do have some questions.

15 THE CHAIRMAN: May I suggest that we are very careful not to duplicate any of the matters
16 that have been covered already.

17 MR. VAJDA: Yes. Can I also say this: brevity is not a characteristic I have noticed in
18 Dr. Williams’ answers, and I would ask, Dr. Williams, the questions I ask that you can be
19 brief and if the Tribunal might intervene because otherwise this cross-examination might go
20 on longer than otherwise. I am anticipating no more than 45 minutes or so, but obviously it
21 depends a bit on how Dr. Williams answers. What I am looking for is short answers.
22 Obviously if Dr. Williams feels it needs a long answer, do it, please, briefly.

23 MR. RANDOLPH: Madam, if I could just clarify my position, I have got some questions
24 planned, but they may well be dealt with by Mr. Vajda and in that case obviously I will take
25 what you have said with regard to duplication not only of Miss Carss-Frisk, but obviously
26 Mr. Vajda. I would hope very much that I would be focused, and I would just reiterate the
27 point that Mr. Vajda has made with regard to brevity.

28 THE CHAIRMAN: Thank you, Mr. Randolph. Dr. Williams, you have heard what has been
29 said. I know this is a very complicated matter, and of course you must explain your
30 position as best you can. If you can keep your answers brief that would help us to get
31 through this. A. I understand. Thank you, I’ll do my best.

32 Cross-examined by Mr. VAJDA

33 Q Dr. Williams, I am going to start with a few questions on market definition. Do you agree
34 that the market definition issue here is whether new and replacement meters are in the same

1 market as Legacy Meters? A. I believe that's the question.

2 Q Do you agree that in answering that question one has to look at the facts that relate
3 specifically to Legacy Meters and new and replacement meters in the years 2002 to 2007?

4 A. In the interests of being brief, if I may, I will try and refer back to some things I've said
5 earlier. Basically, we had a discussion earlier about whether, in market definition as
6 opposed to market power about exactly whether one looks at certainly conceptual
7 benchmarks or the facts, I expressed the view there that one looks at certain conceptual
8 issues. So since we're still on the topic of market definition, the facts might have some
9 relevance, but I go back to my previous stated position.

10 Q I put it to you that in looking at market definition one looks at the position of the facts and
11 one does not look at the position in abstract. Do you agree or disagree with that? A. I
12 think I gave my views on that earlier, and I disagree with that.

13 Q Can I just summarise what I understand your position on market definition is at para.19(a)
14 of your first witness statement. In the interests of brevity I am going to summarise it and
15 perhaps you can just say yes or no. It is at p.868, it begins at 867. In a normal competitive
16 market installed meters are in a different market from uninstalled meters. That is the first
17 point you are making, is it not? A. I will, to assist the Tribunal, say yes as briefly as I
18 can, but I'm conscious that this is a complex matter and ----

19 Q Dr. Williams, we really have to get on. In a normal competitive market are you saying that
20 installed meters are in a different market from uninstalled meters – yes or no? A. For the
21 reasons I stated earlier, yes.

22 Q Thank you. And the reason for that is because installed meters have sunk costs and so have
23 different characteristics from uninstalled meters – is that right? A. That's one of the
24 reasons, yes.

25 Q You look at it, as I understand it, by distinguishing between installed and uninstalled rather
26 than by reference to the date of installation. That was the evidence you gave yesterday?
27 A. Yes, that's what I said yesterday, and I agree.

28 Q That is effectively what you say at 19(a)? A. Yes.

29 Q If we now move to 19(b), I think, as I understand it, you are saying that the position here is
30 different because payment completion did not exist for NG's Legacy based meters. That is
31 what you are saying at 19(b), is it not? A. That's what I'm saying there, and that's what I
32 said earlier, yes.

1 Q So on your view we were not – I say “we”, there was not a situation of normal competition,
2 that is, I think, what you are saying? A. Yes, I was saying that because of the transition
3 and deregulation it was not a normal situation at that time.

4 Q I think your argument is that because there was no normal competition, it was for that
5 reason that new and replacement meters were not substitutes for Legacy Meters? A. If I
6 could go back to what I said yesterday, that was one of the parts of the reasoning but
7 basically there are other parts of the reasoning which I stated yesterday.

8 Q Do you accept that, as a matter of fact, in this situation of abnormal competition that you
9 have postulated in 19(b), new and replacement meters compete with Legacy Meters? A. I
10 accept that as a matter of fact in the circumstances following deregulation, that because of
11 the absence of payment completion arrangements, there was a competitive interaction
12 between them which led to the sunkness and hold-up problems that we’ve described at
13 length, yes.

14 Q Thank you. If we just go to the Commission notice on market definition, which is at bundle
15 A1, tab 22, p.457, para. 17. You are obviously very familiar with this document. If we
16 substitute for “the parties”, National Grid, the question to be answered is whether National
17 Grid’s customers would switch to a readily available substitute, or to suppliers located
18 elsewhere. Applying that approach one can say in the situation of abnormal competition
19 that new and replacement meters were demand substitute for legacy meters? A. Yes, I
20 have said that in the circumstances of the abnormal competition that there was this
21 significant competitive interaction between them. I have of course, to repeat my testimony,
22 denied that that is relevant to market definition.

23 Q Thank you, we can put that bundle away now. In the course of yesterday afternoon, the
24 chairman raised what is known as the Cellophane Fallacy, which of course you are familiar
25 with, Dr. Williams. Do you accept – if I can just tell you what I think the Cellophane
26 Fallacy is – where you have excessively high prices you may suck into the market products
27 that would not normally be in the market and you might get a wrong market definition. Is
28 that accurate? A. Yes.

29 Q Do you accept that the Cellophane Fallacy has no application in the present case, because
30 the prices at which Grid was supplying its meters were price capped? A. No, there is a
31 confusion here which I need to elaborate. The basis of my argument here about the market
32 definition was about whether there was competition between new and replacement and
33 legacy meters against the benchmark of what we have called ----

1 Q Sorry, Dr. Williams, could you answer my question: is the Cellophane Fallacy applicable to
2 this situation – yes or not? A. I am sorry, but this is a complex matter and “yes” and “no”
3 to questions ----

4 Q Well perhaps you could say “yes” or “no” and then give your reasons. Is the answer “yes”
5 or “no”?

6 THE CHAIRMAN: Well I think that is a little unfair. What I understood you were saying
7 yesterday was that it is relevant not because we have a monopoly pricing situation here, but
8 there is another abnormality in the market similar in effect to, but in fact different from the
9 existence of a monopolist pricing at the monopoly level, and it is that other kind of
10 abnormality in this market that sucks in substitutes which, in an ordinary competitive
11 market would not be considered substitutes? A. That is roughly what I am saying, yes.

12 MR. VAJDA: I am grateful, madam. (To the witness): So the Cellophane Fallacy is not relevant,
13 but the other point that the chairman put to you, that is relevant, it is the abnormality factor,
14 but it is not the Cellophane Fallacy, it is another abnormality factor? A. I am sorry, I am
15 slightly struggling with this line of questioning. I am not trying to be difficult but I do not
16 quite see ----

17 THE CHAIRMAN: Well whether or not it is the Cellophane Fallacy, what you are saying is that
18 because there is this abnormality in the market it might mislead one into including other
19 products in the relevant market which should not be there.

20 MR. VAJDA: Yes. Can I give you an example, and then ask you a question? Supposing you
21 have three producers in a market, all right? They are all producing substitutable products –
22 okay? One of them is receiving unlawful State aid. So that is a situation, I take it you
23 would agree with, of abnormal competition? A. So you have A, B and C and, say, firm C
24 is getting abnormal State aid – it is getting cost subsidies, or ?

25 Q It would shut its factory but for the aid? A. Yes.

26 Q That is a situation of abnormal competition, is it not? A. That is a reasonable
27 characterisation, yes.

28 Q Now when you then look at the relevant market when you are doing a market analysis, do
29 you take the products of firms A, B and C, or do you just take the products just of firms A
30 and B? A. If one were doing a merger analysis ----

31 THE CHAIRMAN: Can I just be clear, Mr. Vajda, you started off by saying that they were
32 producing substitutable products, but if they are substitutable then would they not be in the
33 same market?

1 MR. VAJDA: They would be in the same market but we have here the position that the witness
2 accepts that, as a matter of fact, the new and replacement meters are substitutable for legacy
3 meters, but he says that we cannot look at that because there is an abnormality in the
4 market. So I am putting to him the State aid abnormality, and when you do the market
5 analysis in that case do you exclude products from producer C because they are abnormal;
6 they should not be on the market? A. If you were doing a merger analysis, a merger
7 between A and B then clearly the fact that C exists would be a fact you would take into
8 account in looking at the competition with A and B, providing of course that you believe
9 that C is going to continue to exist i.e. that the State aid is permanent. If it were not
10 permanent or one had reason to believe it would be withdrawn you might not take it into
11 account, so I think it probably might depend on whether or not one believed the situation
12 was going to persist or not, as to whether or not you included it.

13 Q The point that I am putting to you, Dr. Williams, is that when you do a market analysis in
14 terms of relevant market you look at how the market is as a matter of fact, not whether there
15 is normal competition from that market. Would you agree with that? A. What I have
16 said is that certainly in the cases I have discussed in this case I disagree with that. I agree
17 that it is a complex issue, but basically I broadly support my view from yesterday, but it is
18 complex ----

19 Q In a State aid case, in an Article 82 case, what would the relevant market be in that case?
20 Would it just be the products of A and B, or would it be A, B and C? What is your evidence
21 on that? A. Who is under investigation here?

22 Q At the moment we are looking at an Article 82 case and we are defining the relevant market
23 and what I would like to know is in your definition would you include products from
24 producer C, which were being unfairly State-aided, in that market definition or not?

25 A. What I am saying goes back to my previous point which is if I thought that C was going
26 to be around on a long term basis then I would probably include it, but if I thought because
27 of State aid that this was temporary and it was not, then I probably would not. The
28 analogy, of course, to the situation yesterday is that there was this abnormality in the
29 market which because of the MSA contract did not expect to be around for very long.

30 Q But you would not exclude C just because there was State aid? A. If the State aid were
31 going to be permanent then I would probably factor it in, yes.

32 Q Now, we can move then to 19C, and I just want to clarify this. You see that at 868?

33 A. Yes.

34 Q The sentence you begin:

1 “In particular I understand the majority of N/R meters currently being installed
2 are:

3 i. Replacement for faulty Meters”.

4 Now, “faulty Meters” does that in your understanding include or exclude legacy meters?

5 A. Can I just read this again?

6 Q Yes, of course? A. So the question to me is when I say that many of these are
7 replacement of faulty meters ----

8 Q Yes, does that include faulty meters that are legacy meters? A. That were legacy meters
9 before they were faulty, yes.

10 Q So is the answer “yes” or “no”? A. I think the answer is yes.

11 Q “Replacement for Meters whose accuracy may fall short of the requisite standard”, was that
12 legacy meters, or non-legacy meters, or both? A. Well these were ----

13 THE CHAIRMAN: These were meters which were recovered by the Legacy MSA. A. It
14 depends on the particular timing, of course, as to whether they were, or were not, part of the
15 MSA at this time. These were meters which existed and whose costs had been sunk.

16 Q They are not simply meters which are installed under the new and replacement.

17 MR. VAJDA: I think, Dr. Williams, when you were writing this - and this is your language, not
18 my language - replacement meters or meters whose accuracy may fall short of requisite
19 standard, and you put, “i.e. most policy meters under the MSA” -- I assume you include in
20 that the Legacy MSAs? A. I think I mean this quite generally.

21 Q Do you include Legacy MSAs or do you exclude? A. I think I do include them.

22 Q You include them. A. I didn’t think very carefully about it, but I think I include them.

23 Q If we then go to the next category at (iii) - replacement of a credit meter with a prepayment
24 meter. Is that prepayment meter a Legacy meter or not a Legacy meter? A. (After a
25 pause): Again, it’s a meter that’s already been installed. So, if we’re in a world which ----

26 Q This is a switch? A. This is a switch. Yes. Absolutely. So, whether it’s a Legacy or not
27 -- I mean, under the contract it depends on when exactly we’re talking about. The point I’m
28 making here is simply that when meters are replaced, sometimes there is -- The point I am
29 making here is this: we’re asking, “Are new meters ----“

30 Q Sorry. Dr. Williams, I am asking you a simple question and we want to get on in this case.
31 When you are talking about what I think is called ‘customer requested exchange’, do
32 Legacy meters fall within that replacement category. Yes or no? A. They are a sub-set
33 of it.

1 Q Thank you. (After a pause): Now, the point that you then make at the end of para. 19(c),
2 I think, is that Legacy meters which are already installed into fixed locations and generally
3 cannot be transferred for use are clearly not substitutes for new and replacement meters. I
4 think the point there which you then take up in your second report is effectively that there
5 may be a separate market for each Legacy meter. Is that right? That is the logic of that
6 argument. A. What I'm saying here is that if there is a premises where you need to
7 replace the meter because it's gone wrong, or whatever, then a Legacy meter at another
8 address is not going to do the trick of replacing it at the other address.

9 Q Yes. But, that does not go to the question of whether a new and replacement meter is a
10 substitute for an installed Legacy meter, does it? A. That's a question about whether a
11 Legacy meter is a substitute for a new and replacement meter. So, it's the other half of the
12 coin, yes.

13 Q Now, I think you made the very fair point at para. 12 of your first report that market
14 definition is not an end in itself, but a tool for identifying competitive constraints. Are you
15 suggesting in this case that in terms of finding a tool to assess the competitive restraints on
16 National Grid it makes sense to look at an individual Legacy meter market where one
17 Legacy meter is in a market of its own? A. It depends upon the precise question that is
18 being posed. Market definition is not a sort of homogenous answer. Market definition is
19 indeed a tool in competition policy. Whether or not it makes sense depends on exactly what
20 competition policy question one is being posed. I am sorry if this appears -- but, this is the
21 reality of market definition.

22 Q I can take you to the passage if you hesitate about this, but you seem to be saying in your
23 second report that you are not criticising Ofgem for having failed to do the market analysis
24 in para. 19(c). Do you accept that? A. Can you take me to where I say this, please?

25 Q Yes. If you go to your second report in WS6, at p.3068, para. 30 (which is actually at
26 p.3070) -- -- A. Yes. What I say there is that I have given the analysis of a narrow
27 market, but I do believe that for many practical purposes it might be reasonable to add them
28 up.

29 Q Yes. Yes. Thank you. Can I just ask you a few questions on sunk costs? This is again
30 focusing on the argument you put forward at para. 19(a) of your first statement. This is the
31 argument about payment ... You remember that. A. Where are we?

32 Q Paragraph 19(a) of your first statement, which is p.867. How does your argument about
33 sunk costs apply to a meter that is over twenty years old? A. (After a pause): My
34 analysis of sunk costs says that if you have already sunk the costs it is there, and you can

1 continue to use it. This is nothing to do with whether you have under-recovered or over-
2 recovered. My analysis of the competitive interaction between a Legacy meter that's
3 twenty-five years old, whose costs are already sunk but which is still working, is the same
4 as that of one that is, say, fifteen years old. So, my economic analysis of the competitive
5 interaction does not depend upon the age of the meter, though obviously if it's old it still
6 needs to be properly working.

7 Q But your argument on sunk costs, as I understand it, does depend on age, does it not? I
8 mean, there is a period after which you have recovered the cost. A. No, it is not that.

9 Q It is not that. A. No.

10 Q Can you explain what it is then? A. Yes. Sunk costs are costs that have already been
11 incurred and where you cannot get the money back, and it's basically where the asset in
12 question is in the market without needing to incur that cost.

13 Q Perhaps I can ask you a slightly different question: would you regard, on your theory of
14 normal competition, new and replacement meters as substitutes for meters that have been
15 installed for more than twenty years?

16 THE CHAIRMAN: Is that on the assumption that the rental that has been paid over that twenty
17 years is at least equal to the amount of the sunk cost?

18 MR. VAJDA: yes. A. Okay. I gave the view before that I believe that a new and replacement
19 meter is not a good substitute for a working meter whose costs are sunk, provided that it's
20 protected by payment completion arrangements. So, on the assumption that this twenty-five
21 year old meter I'm being asked to consider is still a good working meter, then it falls into
22 the category of everything I've said before - I don't regard the new and replacement as
23 being an economically relevant substitute given the contracts in place, providing it's
24 working well.

25 Q Even though its payment has already been completed. A. Yes. There seems to be a
26 misunderstanding here. My analysis is to do with the sunkness of the costs and its ability to
27 serve the market going forward, and is nothing to do with whether there's been under-
28 recovery or over-recovery.

29 Q I think you also mention, if we just look at your report, sales as being an economically
30 equivalent arrangement. Do you accept that? A. I say that sale gives ----

31 Q You say, if we just look at para. 19(a), "The result that new meters are not good substitutes
32 for installed meters supplied under normal and competitive conditions, i.e. that provide for
33 payment completion or an equivalent arrangement such as sale". So, you introduced the
34 equivalent arrangement ---- Supposing there had been a sale and the meter had been sold

1 more than twenty years ago. Would you regard a new and replacement meter as a substitute
2 for a meter that had been sold more than twenty years ago A. My analysis says that the
3 incentives for replacement are the same under a payment completion contract and under
4 sale. If the meter in question is still a perfectly good working meter, then for the reasons
5 given earlier I hold by my previous view, and if it's not, then in a sense there's no meter
6 there to be constrained because the meter doesn't exist.

7 THE CHAIRMAN: Then the incentive is whether, as far as the purchaser of the meter who is
8 using it to generate its own income stream in the market in which it is competing, using that
9 asset, is concerned -- whether they would think, "Well, it has been going for 20 years now
10 so I have earned as much as I can using that meter, so I should have another meter", but you
11 are saying if the choice is, "Well, I will continue earning the same earning stream using that
12 meter by using the one I have got rather than buying a new one", the sensible thing would
13 be to keep using the one you have got? A. One of the phases often associated with sunk
14 costs are bygones are bygones, and if you've got this meter and it's lasted longer than you
15 thought, but it's still working, there isn't something massively superior available on the
16 market, you carry on.

17 MR. VAJDA: That brings me to my next question, Dr. Williams. Would you accept that a new
18 and replacement meter is a substitute for a meter that is less than 20 years old when the cost
19 saving and technology gains in acquiring the new and replacement meter exceeds the level
20 of unrecovered sunk cost? A. Could you repeat the question, please?

21 Q It is a rather long question and I apologise for that. Would you accept that a new and
22 replacement meter is a substitute for a meter that is less than 20 years old when the new and
23 replacement meter offers a cost saving which exceeds the level of unrecovered cost and also
24 has technological features that the existing meter did not have? A. I'm not sure I've fully
25 got the question, but if I can convert it into language that I'm familiar with ----

26 Q It is effectively, you have got something on the market which is both cheaper and better?
27 A. Okay. In my analysis I have this very simple condition. You want money to use. It's
28 like the functionality gain, including any cost savings, and whether or not the functionality
29 gains of the new meter, of a new widescreen TV, is greater than the duplicated cost to K1.
30 If that condition is satisfied, that is the sort of first part of the rational upgrading decision.
31 In those cases you would switch. In that case the old meter would be switched out. So
32 conceptually since that condition can sometimes be satisfied a new meter could replace.
33 However, in the facts of the case, my argument from earlier was that, in fact, the gains
34 currently available are generally regarded as being quite small and are therefore, the U1

1 minus U0 term is likely to be sufficiently small that it is highly unlikely to exceed K1. So I
2 admit the question has a theoretical possibility but I actually do not believe it to be true in
3 the facts of the market.

4 Q But I think you would agree with me, Dr. Williams, whether that gain is small or large is a
5 question of fact, is it not? A. Yes, absolutely.

6 Q Thank you. We can now forget about market definition, at least so far as I am concerned,
7 and move on to the question of dominance. I just want to see that I have understood your
8 argument on dominance correctly. What I am proposing to do is to summarise it and you
9 tell me if I have got it wrong – all right. The starting point of your argument is that
10 National Grid is constrained by the price cap, so it could not charge super-competitive
11 prices – that is the starting point of your argument, is it not? A. It's a three prong
12 argument and that's one of the three components.

13 Q The next limb is that the P&M terms do not reflect market power because they are
14 constrained by the price cap? A. No.

15 Q I am sorry, I have obviously got it wrong. Tell me what I have got wrong. A. The P&M
16 terms are constrained by the price cap, but why does that matter? The reason that matters is
17 the argument I gave you earlier about why that is a reasonable approximation to the
18 competitive price.

19 Q We will come to that in a moment. The next step in the argument, I think, and please
20 confirm this or tell me if I have got it wrong, is that to induce suppliers to enter into the
21 Legacy MSAs, National Grid had to offer something that was more favourable than the
22 P&M contracts? A. It had to offer something that was more favourable than the best
23 contract available, so clearly it had to be better than the P&M because that was available,
24 but it would also have to be better than any other contract that was offered to them.

25 Q You then conclude that on that basis National Grid could not exploit, it had no market
26 power to exploit? A. If you put those things together, I say that they could not achieve a
27 price that exceeded the P&M regulated price, and from that, given my previous argument,
28 they could not exploit.

29 Q What I would like to do is just to take you to an important passage in your second report,
30 which is at WS6, flag 22, 3073, para.40. It is the second sentence I want to ask you a
31 question about. In the second sentence you say:

32 "It is widely accept that market power is intertwined with the ability profitably to
33 sustain prices above competitive levels."

1 The first question I want to ask you is, widely accepted by whom? A. I believe that it is
2 widely accepted in the competition policy community and certainly amongst competition
3 policy economists, and it's my view as well.

4 Q You are obviously familiar with the case law of the European Court, are you not? A. I
5 have some familiarity, but I am not a legal expert.

6 Q Let me put a proposition to you and if you disagree with it, tell me. If you take the *British*
7 *Airways* case – are you familiar with the *British Airways* case? A. I have some
8 familiarity with it, but I did not work on the case.

9 Q You are familiar with the *Michelin* case, are you not? In fact, you annex it to your own
10 report, so you are clearly familiar with it. A. I am not familiar with all the details of it,
11 I'm familiar with the case.

12 Q You rely on the *Michelin* decision, do you not? A. Rely on, for what purpose?

13 Q In relation to market definition? A. I cite it, yes.

14 Q You cite it, yes, so you have obviously read it? A. I have in my time read it, but not in
15 detail in the context of these enquiries.

16 Q I am not aware that either in *Michelin* or in *British Airways* it was a requirement for
17 dominance that it was necessary for the Commission to prove that the undertaking in
18 question was able to charge supra competitive prices? A. My view is – two remarks.
19 One, this is primarily, I think, a legal question, though I did give you some remarks earlier
20 about how I personally do have some sympathy, e.g. in predation cases, with a slightly
21 wider view of dominance. Whether it is wider or not is a legal question, and I do not know,
22 but I think I have given my view on that before.

23 THE CHAIRMAN: Yes, I think we are covering ground ----

24 MR. VAJDA: To some extent, because effectively, and this is as I read your report, your report is
25 very much focused on prices, and what I am putting to you is focused on what one might
26 call exploitative abuses, which we are not dealing with here. We are dealing with
27 exclusionary abuses. A. I believe we covered this ground earlier, and I thought I gave an
28 answer to that, which is even if I had asked the exclusionary questions, actually I didn't
29 think this was a market which was particularly ripe for an exclusionary abuse, but I do
30 believe I answered extensive questions on this earlier and I refer to my previous answers.

31 Q All right, on the “widely accepted” your evidence is that it is widely accepted by
32 economists, but you accept that the legal position may be different? A. The law is the
33 law.

1 Q That is a pretty safe answer, I think! You will not get into any trouble with that. The
2 second assumption that that makes is the price cap – and this is something that you have
3 said again in evidence today – reflects the competitive price. Now, I put it to you that the
4 price cap does not reflect the competitive price? Do you agree with my question?

5 A. Well there was a long debate between experts in the matter ----

6 THE CHAIRMAN: Sorry, is your question whether it does now, or whether it did when it was
7 set?

8 MR. VAJDA: At any time. What I am asking this witness, because this witness appears to have
9 equated price cap with the competitive price and I say that is – (To the witness): well, am I
10 right that you have equated the two, a price cap and a competitive price? A. I have said
11 that the regulated price at the time of a price cap is a very good approximation as to what
12 the competitive price would be. In most cases we haven't got a clue what the competitive
13 price is, and it is incredibly difficult to work out and there is no real way of doing it. What I
14 am saying is that here is a market where, without us having to worry about this, we have a
15 regulator who went through a long process to say: "This is the capital base, this is a fair
16 return on capital" and what I am saying is that that is a closer approximation to what the
17 true competitive price, if anybody could ever work it out, is than we are ever going to get, I
18 think that is what I am saying.

19 Q I put it to you that the price cap and the approach that Ofgem did, wearing its regulator's
20 hat, was to reach a price that was a reasonable price for the regulated company, taking
21 account of its historic cost base, and that is a different exercise from determining – and it
22 does not equate to the competitive price? A. First of all, I believe that this is effectively
23 the subject matter of yesterday's debate, but if you want me to offer an answer I will do so.

24 THE CHAIRMAN: Is your point that the price cap was not set on the basis of efficiently incurred
25 costs, but on costs in fact incurred?

26 MR. VAJDA: No, my point, madam chairman, is that the price cap is simply a cap, which is what
27 is a reasonable amount of money, or a reasonable price that National Grid should be able to
28 charge for its meters based on its costs, but it is a completely different point as to what the
29 competitive price in the market is, because the competitive price in the market is effectively
30 what people are offering out there, that is the point I am making, but I am cross-examining,
31 I am not actually making submissions, but it is very important, because what I want to
32 explore with this witness is how he perceives the price cap, because running through this
33 great theme of the report is that there can be nothing anti-competitive going on here,
34 because effectively what is happening is that prices are lower than the price cap. So it is

1 important that we get Dr. Williams' evidence and not my submissions as to what he thinks
2 the price cap does do and what it does not do? A. As regards what it did and did not
3 include I have to defer to things yesterday because I have no expert knowledge of those
4 matters. I go back to a remark I made a few minutes ago, in most competition cases we do
5 not have anything that would give even a clue as to what the competitive price at a
6 particular moment in time is. In my analysis earlier I said that I believe that the relevant
7 point in time was in a sense when the costs are incurred, but that the wonderful thing about
8 the regulatory thing is it did give us a snapshot at a moment in time, almost as if they all
9 came into existence at that moment in time.

10 So in a sense I really cannot add much more to what was added yesterday on this; this is not
11 my expert testimony. I work, however, on the following points. In assessment of market
12 power my understanding is that market power is a situation where you are able to
13 appreciably and sustainably raise prices above the competitive level, and since the empirical
14 evidence appears to be the price is significantly below that level, what you would need from
15 market power is to have the ability to raise appreciably above that level, there seems to me
16 to be here a wide gap between what has happened and where you would need to be for there
17 to be significant market power.

18 Q That evidence, of course, depends on you being right that for there to be market power you
19 need to price supra-competitively, does it not? A. We had a debate five minutes ago
20 about whether market power is just about supra-competitive pricing or whether it also
21 includes what I earlier described as the monopolisation issues, and obviously to the extent
22 that I give analysis on price raising power then that is only fully decisive if correct in a
23 world where price raising power is the only question; that is a question for you. I did also
24 remark that if, in fact, you want to look at the other issues, in a broad brush way I did not
25 think that the features were conducive but one might prefer simply to do your full analysis
26 of whether they are or they are not exclusionary.

27 Q Looking at the market as it was, say, in 2005, with the CMOs coming in, is your evidence
28 that the price cap is the same as the competitive price or different from the competitive
29 price? A. I gave evidence earlier that basically in a market where you have ----

30 Q Can you just answer the question? It actually does admit of quite a simple answer. In 2005
31 with the market as it is, do you regard the price cap as being the competitive price – “yes”
32 or “no”? A. I am sorry, I am not prepared to give a “yes” or “no” to that. What I said
33 earlier was that we have generations of contracts and basically I regard the regulated price
34 in 2002 as being the competitive price at which long term contracts would be offered in

1 2002, but which would still be active on the market in 2005, and so when I am asked: “ Is
2 that the competitive price in 2005?” Answer: Yes, for all contracts still on the market in
3 2005 that were signed in 2002, but I agree that if there has been a fall in cost that it would
4 not be the price at which new long term contracts in 2005 were being issued. I believe I said
5 that earlier and I maintain that position.

6 Q Yes, well I think we are making some progress here. If we look at, say, and I know as an
7 economist you need to look at the period over time, if one looks at the position between
8 2005 and 2008, contracts that are entered into, I think your evidence is that the competitive
9 price is lower than the price cap? A. I am not a witness of fact here, but since I believe
10 that costs have been falling I believe that the price at which long term contracts are now
11 entered into are below the price cap, yes.

12 Q Could I ask you to turn to p.877 of your first report, para. 58? This is under the heading:
13 “Market evidence”, do you see this? A. Yes.

14 Q Can I just ask you to read to yourself, and the Tribunal, para. 58? A. (After a pause) Yes,
15 I have read it.

16 Q Now, I put it to you that the price cap is not a relevant benchmark because it is above the
17 competitive price. Do you agree with that? A. No, I disagree with that for the reasons I
18 have elaborated several times, because you have to look at the relevant period of time.

19 Q Well I am looking at 2005/2008, would you agree with that or not? A. What I am saying
20 is the following: if, in fact, there were some new contracts issued, supposing you were
21 looking at the new and replacement market, and you were wanting to wonder whether or not
22 those prices were competitive, and those contracts were being issued in 2008, then since in
23 this world we are in 2008 then what was the reasonable approximation for competitive
24 pricing in 2002 is probably no longer relevant.

25 THE CHAIRMAN: So is your answer then that it is a competitive price for National Grid’s
26 contract because that was entered into at the earlier date but it would not be a competitive
27 price for a new contract to be entered into? A. Yes, the evidence I gave earlier is when
28 you are investing in these long assets with long contract lives basically they have to be
29 competitive at that time, but that if you now take a snapshot in time of the market in 2009
30 you will find that if this market has been running for a long time there are contracts of all
31 sorts of vintages and obviously assuming prices falling continuously through time the ones
32 that were signed very recently are going to have low rental prices, and going back through
33 time, but they will all be present in the market at this point in time. But if you want to know

1 whether or not they were reasonable one asks about that in the context of the time in which
2 those costs were incurred.

3 MR. VAJDA: Thank you. I think we can move on to another topic, which is the “hold up” point
4 – do you recall the hold up point? A. Yes.

5 Q I hope we can do this simply by reference to your second statement, which is in WS6.
6 My first reference is at 3077. Do you recall there is a debate between you and Professor
7 Grout as to the relevance of sunk costs? Professor Grout says, “Well, actually it’s a barrier
8 to entry”, and you say, “Well, actually it’s the hold-up point”. I am over-simplifying, but I
9 am a mere lawyer amongst these distinguished economists. Is that a fair summary A. I
10 recall that debate. We discussed it yesterday.

11 Q Yes. Now, you say, in disagreeing with Professor Grout,
12 “My conclusion rests on the concept of the hold-up problem - a widely recognised
13 result in economics”.

14 Do you agree that whether or not there is a hold-up problem depends on the facts of a
15 particular case? A. Yes.

16 Q Just to give an example, supposing a I built a nuclear reprocessing plant. I have enormous
17 sunk costs. All right? I have the only plant in the world. All right? Nobody else -- Just let
18 me finish. There is no other plant being built. There is not going to be a hold-up problem in
19 that case, is there?

20 THE CHAIRMAN: Who is holding up who?

21 MR. VAJDA: The argument, as I understand it -- The hold-up problem, as I understand it, and
22 again correct me, Dr. Williams, if I have misunderstood your evidence, is that I think you
23 are saying that once somebody has sunk a specific cost - and the larger the cost that has
24 been sunk, if you like, the bigger the effect - that person is vulnerable to being, as it were,
25 almost held up to ransom by somebody who is going to deal with him because he has
26 actually sunk the costs. That is your argument. A. Yes.

27 Q That is the hold-up point, is it? Yes. Dr. Williams accepts that whether there is a hold-up
28 point in a particular case depends on the facts of that case. A. Yes.

29 Q Then let us go to para. 58 where you discuss the whole hold-up point on the facts of this
30 case. Can I ask you and the Tribunal just to read to yourselves para. 58 before I ask you a
31 question on it? (Pause whilst read): The question that I would like to ask you, Dr.

32 Williams, is that you say in the last sentence,

33 “For Legacy meters it [that is, National Grid] had sunk its costs whereas the gas
34 supplier was free to walk away and contract with a CMO”.

1 I would like you to expand on the words 'free to walk away' and 'contract with a CMO'.
2 Did you mean immediately? A. I meant - and I think I'm talking about this in the context
3 before the MSAs have been signed - that basically they would be free to start contracting.

4 Q Putting this in time, this would be --? What year would you be looking at? 2001, for
5 example? A. At any point before the MSA was signed.

6 Q Can you recall when? They would have signed in January 2004. So, your evidence is that
7 you are looking at the period -- We obviously need to be fact-specific here, do we not? So,
8 we are looking at a period before January 2004. A. I can't remember exact details of
9 when every contract was signed, but if that's when they were signed, then, yes.

10 Q So, the important point is that you are looking at the period before the Legacy contracts
11 were signed. A. That's when the whole of the problem ----

12 Q Yes. Yes. Yes. Now, I just want to focus on the words 'free to walk away'. Can you just
13 explain what you meant by that? A. Yes. That basically they were renting meters and
14 that for some of those meters they were free to walk away, i.e. they didn't have to buy them
15 or make any payment for them. They could just leave them on the wall earning no return
16 because they were going to get their services from metres installed by a CMO. I think that
17 is what I meant.

18 Q Did you mean that they could do that overnight? A. No. I think it's clear in my report
19 that I fully understand that this will occur over a period of time, but the first one ----

20 Q What period of time did you have in mind? A. When I wrote this report I was aware that
21 there was a lot of interesting debate about exactly what period. My analysis here does not
22 depend upon the precise period. My conclusion is that basically they will recover less than
23 their cost. I have already said that, of course, the quicker they walk away, the less they're
24 going to recover, but my generic conclusion that they will recover less than their costs
25 stands. Quite how much less depends on how quickly they would walk away.

26 Q I am slightly puzzled. You say your analysis does not depend on how quickly they would
27 walk away. Supposing that they could only walk away in twenty years. Would that not
28 affect your analysis? A. Sorry. I must have mis-spoke. Quite how much they are
29 vulnerable depends on how quickly they believe that they can walk away.

30 Q Right. You are giving expert evidence. You tell us all the material that you have read
31 before producing this report for the Tribunal, to assist the Tribunal. What did you have in
32 mind here when you said 'free to walk away'? How many years? I think your evidence is
33 that you did not have overnight in mind. How many years did you have in mind when you
34 used the words 'free to walk away'? One year? Two years? A. What I had in mind here

1 was -- There's a generic point here that simply means they could move away over some
2 period of time. I was fully conscious that there was a major factual debate about exactly
3 how long, and I wanted to ensure that the evidence that I gave here basically was robust,
4 depending on all of the plausible answers to that. The precise numbers will of course vary
5 with whatever everybody decides was the reasonable period, but my, if you like, conceptual
6 point here does not depend on that number. The only exception would be if it was
7 impossible to substitute over any period of time.

8 Q I am analysis -- or, asking you, in a sense, the robustness of your assertion at para. 58. You
9 accept that the longer it would take them to walk away, the more marginal it would become.
10 So, I come back to the question: How many years did you have in mind when you drafted
11 that at para. 58? Was it five years? Ten years?

12 THE CHAIRMAN: I think, Mr. Vajda, he has answered. His answer is that he did not have any
13 figure in mind. As long as they can move away before payment is complete ----

14 MR. VAJDA: That is not his evidence, madam, with respect. Dr. Williams, what is your
15 evidence? A. My evidence that here I am making a conceptual point about them walking
16 away. Basically, as I have already said, and I apologise for repeating, I was aware that
17 there was debate about what was a realistic timetable. My conclusion, I think, stands for
18 any of the answers to that debate. As to exactly how big the stranding risk was would
19 obviously depend on which of those answers one goes with. Technically, actually, it's more
20 what was in National Grid's mind about those rather than the actual truth. So, basically, my
21 generic result is, I believe, robust to all of the answers that one hears, but the precise
22 numbers - and I don't have any numbers here - would obviously depend. I deliberately did
23 not form an expectation precisely because I was aware that there was factual debate. I made
24 a statement that was basically true under all of the possibilities that were being argued here.

25 Q Is this a fair way of looking at para. 58: that this is just an expression of theory, but not with
26 reference to fact? A. No. Obviously my analysis here is ----

27 Q Well, it is either theory or fact. If it is fact, can you tell us what facts it was based on? A.
28 It's clearly economic theory. The question is: It has an in-built assumption.

29 Q What is that inbuilt assumption? A. The in-built assumption is that it is possible to
30 replace meters over some period of time. I was aware that there was a factual debate about
31 what that was, which is why I basically made a general statement. I fully accept that the
32 precise numbers would depend on that. I don't know what more I can say on this. I think
33 I'm very clear.

1 Q I do not think I can take that further. That is very fair of you, Dr. Williams. I think we can
2 put that away. I am coming to the end. I have got a few more questions on your first report.
3 (After a pause): If we could take that up at p.871 -- We are still on the issue of dominance,
4 Dr. Williams. What I want to explore now are some of the other factors on dominance.
5 The first question I want to explore with you is the issue of market share. All right?
6 A. Yes.

7 Q Can I just ask you to read to yourself para. 27 of your report? (Pause whilst read):
8 A. Yes, I've read it.

9 Q Yes. The point you make there is that the existence even of a high market share does not
10 necessarily imply the existence of market power. Would you accept that consideration of
11 market share over time is important when assessing market power? A. It depends
12 critically on the nature of the market, the form of the competition there. Sometimes yes,
13 sometimes no.

14 Q Yes. A. Sorry, I think I said not yes, I said sometimes yes, sometimes no.

15 Q You must agree, I take it, that market share is important. If we just look at 869 of your
16 report, you set out very helpfully the OFT guidelines at 21(a), which talks about market
17 share. I just want to get your evidence on this. You accept that it is important to look at
18 market share. It may not be the only factor, but you accept it is a factor? A. No.

19 Q You do not ---- A. Can I say, I accept that there are some market circumstances where
20 market share is important, and there are some where it's actually not important at all.
21 Which are which follows from very careful examination of the facts.

22 Q Would you think it would be safe to do a dominance analysis without looking at market
23 share? A. I'm not a lawyer, and my brief knowledge tells me that sometimes ----

24 Q Would it be safe for an economist to do a market power study without looking at market
25 share? A. Absolutely.

26 Q So you disagree with the OFT guideline then? A. Yes.

27 Q I see, thank you. I take it you also then disagree with the OFT that you need to look at
28 disparity in market share. You would regard that as being irrelevant as well? A. No. I
29 need to go back to what I said before. I said that whether or not there is market power, you
30 have to do a careful analysis, blending economic analysis and facts in any particular case.
31 In some of those cases, in a sense, yes, market power is a concept. If we equate it, for
32 example, with price raising ability, then market power, you ultimately are looking at prices
33 compared to cost.

1 THE CHAIRMAN: Can you just answer the question. Do you accept or not that disparities
2 between the market share of one company, whether it is an oligopoly or whether it is a
3 fragmented market, do you consider that looking at that is relevant to the assessment of
4 market power? A. Sometimes yes and sometimes no.

5 MR. VAJDA: Thank you, madam, I am grateful for your intervention on that. Can we then move
6 to barriers to entry, which are dealt with at – you set it out in the OFT guideline, which is at
7 869, do you see, at the end they refer to barriers to entry? A. This is where it says low
8 barriers to entry?

9 Q Just a little bit higher. Let me put the question to you, Dr. Williams. Do you accept that
10 barriers to entry are relevant in assessing market power? A. In circumstances where
11 there's a large incumbent then I accept the analysis of barriers to entry, properly understood,
12 is relevant.

13 Q Thank you. Can you tell me where in section 4 of your report you deal with barriers to
14 entry? A. I don't think I explicitly deal with it in section 4.

15 Q No, I do not think you deal with barriers to entry ---- A. Can I make a remark, however,
16 which is of course that the key barrier to entry alleged in this market is the MSA. Basically,
17 the entire case, including all of my evidence about its properties, is essentially evidence
18 about whether there is or is not a barrier created by that point. That is the key barrier to
19 entry which I believe is alleged. So, yes, it's not dealt with here, but I believe that my
20 evidence contains ample discussion on that fundamental question.

21 Q You say that the key barrier to entry alleges the MSA. Could I ask you to take up CB1, the
22 Decision at p.56. Could you just give a quick skim to paras.3.66 to 3.71. A. There are
23 various things mentioned there, yes.

24 Q You have obviously read this because you said in your report that one of the things –
25 obviously a pretty key document in this case is the Decision, is it not? A. I've read this,
26 yes.

27 Q How does that square with the evidence you have just given me and the Tribunal for that
28 matter that the key barrier to entry here is the MSA? A. I should perhaps explain.
29 Suppose these other factors were irrevocable barriers to entry, in that circumstance entry
30 would not be possible for reasons nothing to do with the MSA, in which case the MSA
31 could not actually be preventing entry that otherwise would have occurred. So I apologise,
32 there are other factors mentioned here, but it was my assumption that the issues in this case
33 is that these factors mentioned here would not have stopped entry occurring, and that the
34 thing that stopped entry occurring is the alleged – the anti-competitive MSA. So, sir, I

1 apologise in the sense that these factors are here, this is my interpretation of what I distilled
2 as the essence of this case.

3 Q Where is it in your report that you address the facts at para.3.68 of the Decision? A. I'm
4 not sure I discuss these issues.

5 Q I do not think you do, do you? A. I'm not sure I do. I may do, but I'm not sure I can
6 point to it.

7 Q I have no further questions.

8 THE CHAIRMAN: Mr. Randolph, do you have anything you want to ask?

9 MR. RANDOLPH: Madam, yes, I do. Fortunately Mr. Vajda has covered a number of areas or a
10 number of questions that I was going to ask, so I do not need to ask them, but I still have a
11 few, if that is all right. Looking at the time, I fear that it might go slightly beyond one
12 o'clock, so perhaps it might be possible to rise slightly early then come back slightly earlier
13 than usual.

14 THE CHAIRMAN: Yes, I think that makes sense. We will resume at two o'clock. Thank you.

15 (Adjourned for a short time)

16 (After administrative matters)

17 Cross-examined by Mr. RANDOLPH

18 Q I can promise you one thing, Dr. Williams, we are not going to go into any algebraic
19 formulae – at least I am not going to, maybe you will.

20 THE CHAIRMAN: They crop up when you least expect them! (Laughter)

21 MR. RANDOLPH: Indeed, let us hope in the next 10 minutes they do not. Dr. Williams, a
22 general question first. Would you agree with me that your approach at the least could be
23 described as unorthodox in this case, your reports are unorthodox? A. I believe that I
24 have applied my skills as a micro-economist to the facts of the case, and derived
25 conclusions on that basis. I believe that is what I have done and some conclusions might
26 come out that might surprise people but I believe I have just done what I normally do.

27 Q You have done what you normally do, but I put it to you that on the basis of the evidence
28 that you have given over the last day, where you have admitted that in parts you have
29 ignored reality, you have said this morning I think that market definition was “almost
30 irrelevant”, and you said that market shares with regard to dominance was irrelevant. I am
31 not getting into whether these are right or wrong. Obviously you understand that I do not
32 accept and I do not agree with your conclusion, I am just saying that it is unorthodox.
33 Those approaches where you have ignored reality for the purpose of market definition, you
34 say that market definition actually is almost irrelevant in a dominance case, and you say that

1 market share analysis is irrelevant in effect – I am not saying whether it is right or wrong it
2 is just unorthodox - yes? A. No.

3 Q Okay, fine. So do you agree with me that in Article 82 and Chapter II cases – and we are
4 looking at a Chapter II case here, yes – abuse case? A. Yes.

5 Q That you need to look at market definition, you need to define the relevant market?

6 A. There is a legal question about whether you have to define the relevant market, and
7 obviously that is the legal view. In terms of my claim about the relevance of market
8 definition I think if you look on the transcript you will see I make remarks like the
9 important thing is, is there market power? Are there competitive restraints? My remark
10 about “irrelevant” was that where you classify those cannot affect any substantive outcome,
11 and that was the basis of that claim.

12 Q Absolutely, Dr. Williams. This is where I shall be coming to. Your concern is about
13 market power. In much of your report your concern is about market power, and that is what
14 you just gave an answer to saying the key point here was market power, but I put it to you
15 that in order to get to issues of market power you really do have to look at and examine the
16 logically prior question, be it legal or economic, of the definition of the relevant market.
17 You cannot just hop over that and go straight to market power, would you agree with that?

18 A. As a matter of law I make no comment, but I am aware of what the process is. As a
19 matter of economics I believe market power in a sense is a fundamental concept and that
20 frequently one can and does hop over market definition in order to answer the fundamental
21 question.

22 Q I see, so your approach would be that you can analyse market power without previously
23 analysing the market in which the power is to be analysed? A. The idea of direct estimate
24 of market power is now quite well understood in the economics’ profession.

25 Q Good. You say, Dr. Williams, and you admit very fairly both in your written report and
26 orally, but certainly orally, that there was a certain paradoxical nature – you were going
27 through this yesterday in your evidence – where, on the one hand, you were saying that
28 legacy meters and new and replacement meters were in different markets – that is the one
29 hand; and then the other hand that new and replacement meters exercise [quote] “a
30 significant disciplinary role” with regard to legacy meters. You said that was slightly
31 paradoxical, you admitted that, which is fair enough, but then you said that effectively that
32 did not really matter because – certainly your evidence yesterday was it did not really
33 matter because of the basis of the exercise of Grid’s monopoly power, and then you went
34 into what you might want to look at and why reality was not terribly relevant. Do you

1 accept that? A. That summed up quite a lot of things, but basically I said what I said
2 yesterday and I remain of the view that the fundamental questions here are about whether
3 there is market power rather than market definition and I maintain my view that how you
4 classify competitive constraints does not change reality, and therefore there is a certain
5 degree of irrelevance of market definition; I have said this several times and I maintain my
6 view.

7 Q And that approach entails, you have admitted, a certain seeming paradox; you do not seek to
8 explain it but you admit that there is a paradox? A. When I refer to the paradox, yes,
9 several people had, in proceedings said, “hang on a minute, you are saying this is powerful
10 competitive constraint and it is not in the market.” Actually, the way in which I think I
11 ultimately characterised this is that it was actually the threat of replacement that was doing
12 the discipline here and, as such, I saw that naturally as entry to the market especially as the
13 entrants had not yet sunk their costs in the household. So it was actually for that reason that
14 I classified it in my mind more of an entry threat and entry threats are naturally classified as
15 outside the market. But it remains my view that, in a sense, where you classify things will
16 not affect the answer to the fundamental market power question. I was hoping to try and
17 explain why ----

18 Q That is fine, that is where we diverge. We said that you need to look at the relevant market,
19 and that is not irrelevant, and then you can go on to market power, but that is fine. I wonder
20 if we could stray from the ivory tower – the theoretical approach – and go into the real
21 world, if you do not mind, during the relevant time period? So I am looking at the time
22 period after January 04. So we have MSAs in force? A. MSAs signed and in force, yes.

23 Q Sorry, in? A. They had been signed and in force.

24 Q Yes, they are in operation, and we have at least one CMO contract, my client’s CMO
25 contract, Meter Fit’s contract which was signed in 2002 and came into operation in 2002.
26 Let us take your example of Mr. Smith at Acacia Avenue. Mr. Smith has a Grid gas meter
27 in Acacia Avenue, and that would be a legacy meter on your term of origin because it was
28 installed? A. It was already installed there, yes.

29 Q Consequently its costs are sunk? A. Yes.

30 Q Now, the enlightened gas supplier to Mr. Smith decides to sign a contract with my client,
31 Meter Fit, because of its better pricing; that enlightened gas supplier wants to swap out the
32 Grid meter and go to a new Meter Fit meter for Mr. Smith. In your terminology that Meter
33 Fit meter, before it was installed, would be a new and replacement meter, would it not,
34 because it had not been installed and therefore its costs had not been sunk? Yes?

1 A. Before it was sunk it was a new meter, whether it was a replacement I don't know, but
2 yes.

3 Q Okay, N/R we can call it, so you agree with that, good. Now, to the extent that that – I do
4 not think you have denied this – to the extent that that gas supplier, that enlightened gas
5 supplier has swapped an old legacy for a new Meter Fit N/R there is clear substitutability
6 there between the legacy, the installed meter and the N/R meter, and I think the evidence
7 you gave to Mr. Vajda just before the short adjournment was not dissimilar to that you said,
8 the N/R legacy to that extent could be interchangeable, could be substitutable? A. After
9 it was sun k it was used for the functions of the previous one, yes.

10 Q On the supply side, if you will, the position is pretty much the same, and staying in the real
11 world, away from Mr. Smith though, but in the real world, someone in the gas meter supply
12 business – I wonder if you could turn up WS5 and turn to Tab 17, p.2824. Have you had an
13 opportunity to read all the witness statements in this case? A. I believe I've read -- I
14 cannot remember, to be honest.

15 Q Absolutely. This is not a memory test. If you cannot remember, you cannot remember.
16 You are probably doing your best. There have been a number of witness statements. This is
17 the only one on behalf of Meter Fit. This is Mr. King who has made the witness statement.
18 At paragraph 2824,

19 "From a CMO perspective, all meters are a homogenous group with no sensible
20 distinction between Legacy and N/R meters: meter manufacturers produce credit
21 and prepayment gas meters, not Legacy and N/R meters, and both are subject to
22 customer-driven activity such as functionality exchanges that does not distinguish
23 between legacy and N/R meters and domestic credit meters and prepayment
24 meters".

25 Would you agree with that as a matter of fact? You have no reason to deny it? A. He's
26 saying how he sees it from a CMO's perspective.

27 Q Yes. A. He said what he said.

28 Q Yes. That is the real world. A. That's how he sees it.

29 Q Yes. In the real world. So, from Mr. Smith's perspective - Mr. Smith in 16 Acacia Avenue
30 - he has a swap-out. You have got Mr. King, in the real world, thinking, "There's no
31 distinction". Now, you say first of all that market definition is not terribly important here,
32 or irrelevant, because you have got to go straight to market power and, in any event, the
33 critical distinction you seek to draw between N/R and Legacy meters is - and do tell me if I
34 have got this right or wrong - this horrible word 'sunkness'. It does not really exist as a

1 word, but -- Sunkness. The distinction that you seek to draw - certainly in your witness
2 statement at para. 10 between Legacy meters on the one hand which have sunk costs and
3 N/R meters on the other which do not have sunk costs. Is that right? A. I discussed
4 sunkness at great length.

5 Q Yes. You would agree with the summary I have just given. A. Broadly, yes.

6 Q Yes. Good. Just a small point, and you may be able to explain this, but I have not been
7 able to explain it -- Could you turn to the Decision which obviously is quite important in
8 these proceedings. That is CB1, para. 3.1 at p.43. This is the section in Ofgem's decision
9 on market definition and dominance. At the top of the page it says, '3 - Market Definition
10 and Dominance'.

11 "The Authority finds that National Grid holds a dominant position in the market
12 for the provision of installed domestic-sized gas meters and the ancillary service
13 of meter maintenance in Great Britain".

14 So, the main market is the provision of installed domestic-sized gas meters. I think in your
15 report you refer to paras. 3.13,

16 "The Authority's view is that the characteristics and intended use of Legacy and
17 N/R meters do not differ. Legacy meters are meters which have been installed
18 before a certain date; N/R are those installed after a certain date ----"

19 You also refer to para. 3.52, which is a few pages on. This is pretty much the same thing, I
20 am glad to say. There is no internal inconsistency.

21 "For the reasons set out above, the Authority has concluded that the relevant
22 market is the market for the provision of installed domestic-sized gas meters ----"

23 Yes? A. It says that.

24 Q Now, my question is this, and, as I say, I do not know the answer: the market is defined as
25 installed gas meters. Now, your whole thesis -- your whole theory with regard to sunkness
26 and the distinction between Legacy and N/R meters depends on the difference between
27 installed and non-installed meters. The Decision is predicated, insofar as market definition
28 is concerned, on meters that have already been installed. So, on its face, Dr. Williams, your
29 distinction as to installed and non-installed meters would seem to be an irrelevance to this
30 case. A. Well I was talking about the threat of replacement.

31 Q Sorry. The --? A. Threat of replacement. The competitive constraint of the threat of
32 replacement. Where are those meters? The meters that were doing the threatening - they
33 don't exist. So, they're not installed. That's why in my mind I see those meters as outside
34 the set of installed meters. They're a potential threat. They, in my judgment, had a

1 significant disciplinary role, but they never actually existed. I think that's what I'm saying
2 here.

3 Q Okay. But, you will not deny that the Decision is based, insofar as this is concerned, on
4 installed meters alone. If that were right, then all of them on your definition -- It is not the
5 legal definition. We do not need to go there. All of the meters in question would be, under
6 your terminology, Legacy meters. There would be no distinction because all of them would
7 have been installed. So, there would be one big market. There would be no distinction
8 between Legacy and N/R, would there, on that basis? A. Well, first of all, I repeat, all the
9 ones that exerted the competitive discipline, which are the ones I was saying, although I
10 believe it makes no difference, should be classified outside the market have never come into
11 existence.

12 Q The Decision, of course, is based, looking at the question of time -- You are looking at the
13 abuse. The abuse derives from the operation of the MSAs over the relevant period, and
14 effectively the cut-off period is somewhere 2007/08 But, the start period is 2004. It is the
15 operation of the MSAs. As I say, the market defined is installed meters N/R and Legacy,
16 insofar as there is a distinction. To that end it seems to me that this cuts across completely
17 your theoretical approach with regard to sunkness because it does not reflect the reality of
18 the Decision. A. I don't accept where this is going. I would just also remark that there
19 are various reasons given in my reports for why I believe that they're different. Something
20 which hasn't really been discussed is different conditions of competition. It's extensively
21 set out in my report. Basically I say that for meters that have been installed, essentially there
22 is a bargaining game between National. Grid and the gas supplier, albeit there is one in
23 which there is the threat of going outside. However, when you look at what I believe they
24 call new and replacement market that is a situation where various companies are competing
25 with each other to supply new meters. That has many of the characteristics of a more
26 normal market where companies are bidding to see who is going to get the supply. Then
27 there is the third set, of course, which is the threat of replacement which never actually
28 happened.

29 So, basically I've given various reasons, but I do believe, ultimately, as I say, the
30 classification is somewhat irrelevant, but I do believe that as an economist one would want
31 to look at these segments quite differently. There are quite different mechanics of
32 competition there.

33 Q Very good. Anything else can be a matter for submissions. My last question to you is this:
34 do you accept that what you have done in your reports is to -- I think "confuse" is not a fair

1 word – “conflate” market definition with market power. You have made it clear in your
2 answers to me that you are focusing in on market power. You have agreed that in your
3 approach you can hop over – my words, which you accepted – market definition. Would
4 you agree, going further on – and do not answer yet – that issues of sunkness might be
5 relevant to market power – I am not going to market power, I am not going to question you
6 about that – but they do not go to issues of market definition, and what you sought to do is
7 bring in issues of sunkness to try and distinguish and differentiate the markets when, in
8 effect, sunkness goes to market power, which is, as I have previously said, or put to you,
9 something that has to be dealt with after market definition. Market definition must come
10 first. What you have done is used sunkness in market definition, whereas it should have
11 been used, if at all, for market power? A. I agree that sunkness is part of market power,
12 and I have used that extensively. It is suggested in a sense that I have improperly imported
13 it into market definition. It’s clear that I have imported it into market definition, but I gave
14 reasons earlier today for why I did that, so I dispute that I have done it improperly.

15 Q I am very grateful. Thank you, Dr. Williams.

16 PROFESSOR STONEMAN: Dr. Williams, the Appeal Tribunal gets training, and in our last
17 training session we had a talk by a very reputable Appeal Judge, and he said that in his
18 opinion for any case all the economists should be shut in a very small room together and
19 locked in until they could come to some agreement, and then that would help the constraint
20 enormously. I think there is something of that going on here today, that people might prefer
21 that we were all locked away until we came to some agreement. I do want to talk to you
22 from the point of view of an economist. I only want to address one point, but it is quite an
23 involved point. In your second report – it is a section that you have already been taken to –
24 at p.36 you say:

25 “To the extent that the Legacy MSA establishes payment completion (...) the
26 replacement incentives it provides are equivalent to those of a straight sale of a
27 Meter.”

28 As you know, that is a very strong result for a economist, because a straight sale provides
29 the sort of incentives we might expect to find in a competitive market, and if we can
30 reproduce that incentive structure with a contract then it tends to mean to us that the
31 contract is really quite desirable. It is a contract to which we, as economists, cannot really
32 object. Would you agree? A. Absolutely.

33 Q The foundation for this is in the same bundle at p.3122/3123. This is the little bit of
34 mathematics, algebra, that most of the lawyers are not really happy about, and our

1 transcribers are going to have some problems with in the other room. It is this section
2 which I think is basically at the bottom of p.3122 and the top third of 3123. Would you,
3 very briefly, just for the benefit of the non-algebraic people in the audience say what this
4 tells them? A. Yes, if I can maybe give an analogy it may help. Essentially, you are
5 deciding whether to upgrade something, e.g. your TV set. Essentially you get benefits,
6 what economists always call utilities, from a good, and you have got this existing piece of
7 equipment and we will call that “equipment zero”, so you get utility or benefits U_0 from
8 that. That might include minimising costs of operating. Then at that moment in time you
9 have basically got the possibility of upgrading to a new piece of equipment, and that one
10 will give you utility level, we’ll call it U_1 , which generally will be expected to be higher
11 than the old level of utility. So what are we saying here? We are saying, “Well the benefit
12 of upgrading is the difference between the two, U_1 minus U_0 ”. However, it is not that easy
13 because, of course, the problem is that if you want to upgrade then you actually have to buy
14 the new piece of equipment, and that is going to cost you an amount which in various places
15 I call different things. In some cases I call it K_1 , I think on page ----

16 Q I think on this page you call it G , so it is probably better that we use that. A. Okay, so we
17 call it G for the cost of upgrading. So that says basically that as an ordinary individual you
18 would decide to upgrade your TV if the extra functionality benefits, including any costs
19 savings from upgrading, exceed the capital cost of the new machine, assuming you are not
20 going to get any money back on your old machine, which in the facts of the case is a
21 reasonable assumption. So essentially that is what you might call the condition for efficient
22 replacement, and I know you will want to talk about whether it is the full set of conditions,
23 etc, but that is the basic profitability condition.

24 The second thing that I’ve done in this analysis is to say, okay, now let’s look at what I call
25 the private incentives. So those incentives I’ve just given there, (a), are the private
26 incentives of an owner, but they’re also absent any externalities, i.e. other things going on,
27 if you like, that equate to the socially or economically efficient incentives, subject to the
28 point I think you’re going to want to discuss.

29 What I then have done is to say, okay, let’s look at what happens under the MSA type
30 contract. There, essentially, all of the real factors are exactly the same as I’ve just described
31 – you get the functionality of a new meter over and above the functionality of an old meter,
32 but you have to basically pay a capital upgrade charge. Provided that market is reasonably
33 competitive then that will basically equal what was it, G , that I was calling it. But, when
34 you actually look at the condition there are a couple of other terms slipped in there. The

1 other terms that are slipped in there are essentially the contractual payments that you have
2 to make. On one side you have got the contractual commitments – this is assuming the
3 MSA has been signed – that the gas company has made to National Grid. On the other side,
4 we have the premature replacement charge.

5 A key point: the whole essence of payment completion – it's nothing to do with the sunk
6 costs – is that is that PRC is set equal to the rental commitment if they don't happen to be
7 equal to each other. In a sense, the grand design of the whole of the MSA scheme is that
8 they are set equal to each other. What that means, therefore, is that essentially they
9 mathematically don't just happen to cancel out, they necessarily cancel out. When they
10 cancel out what happens is that the conditions facing the firm essentially collapse to the
11 case under ownership which we had before. So the essential argument here is that once you
12 realise these things cancel out the very complicated schemes they seem to be facing actually
13 collapse into something unbelievably simple and, by the ownership analogy, innocent.

14 Q I think that will do. A. I think that's the essence of the argument. May I make one
15 further point. The PRC is often in the case characterised as a switching cost. The reason
16 why this algebra has appeared in various places is during the case, in SO 1 the PRC was
17 described as a double-payment, and this analysis goes to show that's not true, and the
18 switching cost equally is not really a cost of switching.

19 Q The essence of this is that PRC is equal to the cost you would have had to pay if you had
20 stuck with the meter that you are replacing. Just a little of background, I just want to
21 establish this and I think you will agree with that it is not a matter of argument between us:
22 you have set this problem up such that you replace when the benefit from replacement is
23 positive? A. If we look at footnote 13, 3122, this is a note I wrote a couple of years ago
24 for them, and what I did there was essentially abstracted from an issue, which is the
25 equation, the inequality side that we have here is what's generally known as the profitability
26 requirement. Is it profitable to upgrade – i.e. is the utility benefit U_1 minus U_0 greater than
27 the capital cost. To go back to the TV example, one may be deciding today whether or not
28 to get a new widescreen TV, and you think, how much extra utility will I get, I'll have to
29 throw the old TV, and how much is that TV going to cost? That may well be positive, at
30 which point you should rush out today and buy it. Hang on a minute, no, actually you may
31 think, especially with the recession, that there's going to be a big sale on next month and
32 it's going to be even cheaper next month. So then there is – and this is sometimes called the
33 inter temporal arbitrage condition ----

1 THE CHAIRMAN: The what? The inter temporal arbitrage? A. I apologise. The inter
2 temporal arbitrage condition, in layman's language I would say that the first condition, the
3 profitability condition, is what I would call the "whether" condition – whether to upgrade –
4 and the second one, which only applies if the "whether" to upgrade decision is answered
5 positively, is the "when" to upgrade decision.

6 PROFESSOR STONEMAN: We are in complete agreement on that, so there is no argument with
7 that. So let us park that on one side for a moment, and let us go back now to the example
8 you have here – as I say, we will put the arbitrage condition on one side for the moment.
9 The example you have here is given the way you have set up this framework the incentives
10 to a renter, given a payment completion contract is exactly the same as the incentive to the
11 owner to change at the same date? A. Yes.

12 Q So there is as much profit going to the renter as there is to the owner? A. Yes.

13 Q Fine. Now, the way you have set this up is that the rental agreement finishes in year 20 –
14 this is a matter of fact, not a matter for response – the rental agreement finishes at exactly
15 the date that meter terminates its life, it is no longer physically operating after the end of
16 the rental agreement? A. Yes.

17 Q What you are saying is that in year 12 of the either ownership or renting, you have an
18 option, you can either stick with the meter to the end of its life, another eight years, or you
19 can replace in year 12 with a new meter for eight years? A. In year 12 you can either
20 stick to the end or upgrade?

21 Q Yes. A. You make this decision every year, basically.

22 Q Yes. And you are saying it is exactly the same result would be the outcome because the
23 rental saved is equal to the PRC that has to be paid? A. Yes.

24 Q You make this decision every year, 12, 13, 14, 15. What is happening to the PRC as you go
25 from 12, 13, 14, 15? A. I am just trying to remember – in this case it is falling.

26 Q It is falling because the rent still to be paid through to year 20 is getting less and less?
27 A. Yes, it is just equal to however much rent you owe until the end of the contract.

28 Q I agree entirely with that. Now, is that an age related PRC? A. Okay, I have to be careful
29 here. It is not related to the age of the meter, but clearly the amount of the PRC that you
30 still have an obligation to pay goes down every year and the meter goes up, it is – like us all
31 – one year older every year, so there is a sense in which PRC is a function of the age of the
32 meter, that that is assuming the particular age of the meter at the start. I am sorry if I am not
33 getting ----

1 Q I think that is a different way of saying it is an age related PRC, because the PRC to be paid
2 declines as the meter gets older. The whole purpose of your construction here is that the
3 PRC has to equal the rental still due, and the way you set it up is that the rental still due
4 depends on the remaining life of the meter? A. Yes, though that is a different sense, I
5 thin, of age relatedness from what I believe I have been hearing elsewhere.

6 Q I do not think so, because I think in that you are in complete agreement with Ofgem – it is a
7 long time ago now – I think it was last Friday Ofgem told me that age related PRCs were
8 perfectly acceptable, they would not foreclose. What they were objecting to were PRCs that
9 were not age related. I want to take your example a little bit further, to see if we can adapt
10 it to PRCs that are not age related. Let us say that the agreement now is not to the end of
11 the life of the meter, this is the rental agreement. Let us say that the rental agreement is that
12 you continue paying rental, but if you leave the contract before year 18 you have to pay a
13 PRC? A. To the ----

14 Q You will pay something but it will not be equal to the remaining rental through to the end of
15 the life of the meter, you would pay the remaining rental through to year 18. So the exit
16 charge would be a rental due to the end of the contract, not due to the end of the life of the
17 meter – does that make sense? A. I think the PRC is always the rental due to the end of
18 the MSA contract not to the end of the life of the meter.

19 Q Right, but the example you have **here** is to the end of the life of the meter? A. One
20 should probably think of it, I think it should be to the end of the contract but that has just
21 happened for simplicity here to assume ----

22 Q Let us assume then it is to the end of the life of the contract, not to the end of the life of the
23 meter, and just for argument's sake, it does not make any difference to the argument, let us
24 say that the end of the life of the meter is 20 and the end of the life of the contract is 18. We
25 consider year 12 – should we replace in year 12. If we are an owner it is exactly the same
26 as before. If we are renting then under the PRC you still will have to pay an exit contract
27 based upon an 18 year MSA, so you will have to pay six years' ---- A. Yes, yes.

28 Q But the rental you will save will be an eight year rental, because the meter has eight years of
29 life left?

30 THE CHAIRMAN: No it has not - eight years?

31 PROFESSOR STONEMAN: Yes, so you will pay six years' PRC but you will save eight years'
32 rental? A. But hang on a second, after six years the MSA has expired, so at that point
33 you are free to renegotiate on that contract for that meter.

1 Q Well, I suppose you could do, but that has not been raised at this stage. I was assuming that
2 beyond that stage you would continue paying the rate of rental that you have been paying
3 for the previous 18 years? A. It is my understanding, though this is a factual matter, that
4 at the end of the MSA contract in a sense all bets are off, and then at that point you can just
5 renegotiate and/or replace, but I think it is a factual matter but that is my understanding.

6 Q Let us go forward on the argument because the issue of renegotiation at the end of the MSA
7 has not been raised as far as I am aware.

8 THE CHAIRMAN: No, and certainly before the end of the MSA, if you keep renting a meter
9 which you could have replaced, you continue to pay the rental as set by the ---- A.

10 During the life of the MSA, the MSA lasts 18 years, any time in the first 18 years you keep
11 paying rentals, or if you stop you pay the PRC which is calculated to be what you would
12 have paid in rentals had you not switched away.

13 PROFESSOR STONEMAN: Now, let us go to year 19, what do you think happens in year 19?

14 A. In year 19 the MSA is over.

15 Q So you do not have to pay any more rental to whoever owns the meter? A. At the end of
16 year 18 the MSA contract now does not exist, it is in a sense at that point, as I understand it,
17 you are now in a world where the party can renegotiate, this is economic analysis. I have
18 assumed that at the end of the MSA that basically the commitment is essentially over and at
19 that point there is free negotiation.

20 Q For the sake of argument, and as economists we are good at saying "Let's assume that ...",
21 so let us assume that in years 19 and 20 that although the MSA is over nobody has made
22 you wise to the fact that you can stop paying the rent and you continue to pay the rent.

23 There has to be some rent paid. All I am trying to do here ---- A. There has to be some
24 rent paid. Clearly there would have to be some new contractual arrangement. Now, it is
25 true at that point clearly by then you can sign another MSA with another CMO etc and the
26 payments that you would make in years 19 and 20 would then reflect the market
27 circumstances of year 19 going forward, so during today I have said basically the price of
28 contracts falls through time.

29 Q I was going to come to that point in a minute. What I am trying to say is we get to 18, we
30 have a meter that has another two years' life in it, although the MSA is now finished. You
31 do not have to, but you stick with the meter, and although you might change the rental, you
32 still have to pay something. A. If you choose to stay with that, I think you have to reach
33 a commercial decision.

1 Q The problem you have set out here on paper is, “Should we change in Year 12 or should we
2 change in Year 20? Should we change the meter in Year 12 or should be hang on to it in
3 Year 20?” I am trying to say, “Let’s do this example under the case where the PRC is
4 payable until Year 18”. A. I.e. it’s an eighteen year MSA.

5 Q Yes. Right. But, you continue to own the meter for another two years, and you continue to
6 pay the rental that you would have paid anyway, although you might reduce ---- A. Yes.

7 Q You would pay something. A. Depending on what is the price of meters at that point in
8 time, assuming functionality has not moved on.

9 Q But would that not mean that in Year 12, looking forward, the PRC to be paid -- If you take
10 the meter out in Year 12 you have six years of rent -- You have eight years of rent still to
11 cover, although the last two years might be lower. A. I dispute that there are eight years.
12 I say we have six years left at that stage.

13 Q So that for the last two years National Grid will be giving this meter away for free. A.
14 No. My claim is that at the end of Year 18, at the end of the MSA, essentially you’re then
15 in a situation a bit like before the MSAs were negotiated. Now, if that meter has got any
16 value left at that point, in a sense there is a residual value to National Grid and they will
17 basically bid that into the market and get what they can for it. I think the question you are
18 asking is: What is the issue here? Is there a residual value at the end of the MSA?
19 Basically under ownership that residual value would go to the owner, whereas under an
20 eighteen year MSA any such residual value would then go to National Grid, if there were
21 such a ----

22 Q No. That was not what I was asking. What I was trying to do was to draw a gap between the
23 payment completion charge payable and the rent saved. A. My claim is that there is no
24 rental commitment beyond Year 18 in this example. Basically, the PRC is equal to the
25 rental commitment.

26 Q Through to Year 20. A. Whatever the length of the contract, the PRC equals the rental
27 commitments for that period of time. What’s happening here is that we’re saying, “Well,
28 hang on a second! Suppose the contract was slightly shorter”. Now, if the contract was
29 slightly shorter, then basically it would’ve been set up so that the rental commitments are
30 equal to the rents that are owed under the contract. But, what we were doing here was, in a
31 sense, assuming the contract lasts both eighteen and twenty years. That’s where the gap is
32 coming from, but that is not meaningful in my view.

33 Q Just to clarify this, can we ask National Grid in some way as to what happens to the rental
34 of a meter after eighteen years on the MSA?

1 MR. TURNER: Yes. What Dr. Williams says is, in practical terms, correct, but not quite so
2 legally. In legal terms what happens is that there is a commitment reflected in these
3 progressively declining PRCs every year, down to Year 18, to rent the meter. If, before the
4 end of that eighteen year period, you remove it, then you have to pay an amount, getting
5 smaller every year, to reflect the commitment. At the end of that period it rolls on, but
6 subject to no commitment at all. So, in those circumstances, in a sense, the buyer is renting
7 on the payment terms, but can pluck out the meter at their discretion. So, in a sense, they
8 have an option to continue or to take out.

9 PROFESSOR STONEMAN: But if they stick with the meter, they still have to pay you rental.

10 MR. TURNER: Absolutely. A. My response to that is that that is a pure option. This has
11 value to the buyer. They are totally free to walk away. There is no exit payment at that
12 point. So, the fact that the contract has got a price, and there's a roll-over in it, is actually a
13 benefit to the buyer, and has no commitment.

14 PROFESSOR STONEMAN: I am not sure I agree with you, but let us move on, shall we? I
15 think I illustrated earlier that with the example -- No. Let us go back to this issue of
16 whether it is more profitable to replace. What we have is two conditions to meet: (1) is it
17 profitable to replace? (2) Is it not profitable to wait? Let us say that there is a PRC to be
18 paid -- or a payment completion payment of some kind to be paid. If that payment
19 completion is due in Year 18 and you are thinking of replacing your meter in Year 18 would
20 you think it might be better to wait until Year 19 when there is no completion payment to be
21 made, because the benefit would be greater in Year 19 than if you replace in Year 18,
22 everything else being held the same? A. (After a pause): Let me just think for a
23 moment. (After a pause): Basically, when you're at the beginning of Year 18, if you
24 switch then then basically you U_1 minus U_0 term from switching, and then you've got the
25 capital cost of the meter, and if you switch in Year 18 you have got a PRC. However, if
26 you wait until Year 19 - and I am really just setting up your point here - then at that point
27 you are out of the MSA.

28 Now, at that point then basically you are back into essentially a sort of P&M world in which
29 there is no such commitment. So, basically, at that point you are free to replace and there is
30 an excess incentive to replace in Year 19 because we have not at that point got an MSA in
31 place. Okay? I can see where you're coming from, but I think the answer is the following:
32 It is true that in Year 18, because of the dynamic arbitrage condition, there are worlds where
33 you would replace in Year 18 where you think, "I would replace in Year 18 if payment
34 completion was also required in Year 19, but since at the end of Year 18 I drop off the edge

1 of the MSA contract, then in that world I basically get my free replacement voucher, and so
2 why don't I wait to get that?" Therefore, it is true - but I have a further point to make at the
3 end - that towards the end game of this eighteen year contract then as you're coming up to
4 the point there might be some very slight distortion of this nature - eighteen years hence.
5 Not now, but eighteen years hence. Except, of course, that assumes that in Year 19 a P&M-
6 type contract is in place. But, of course, we know that those sort of contract structures are
7 inefficient.. Therefore, as you are coming up to Year 19, then just as when we had an
8 inefficient contractual structure at the time of de-regulation, the parties, to the extent there
9 was an inefficiency, rashly re-contracted to an efficient contract, and then shortly before, or
10 even long before, they would have a similar incentive to re-negotiate if the point that you
11 rightly make, which is theoretically, I think, absolutely correct -- If it has any quantitative
12 significance, they will re-contract around it.

13 Q So, I think that the answer to both of my last two questions has been that -- What I am
14 saying is that theoretically correct, but what you would expect in the market is that some
15 sort of new contract form is introduced for meters over eighteen years old. A. Basically
16 as you approach that point, if there is any inefficiency expected at that point, then as you
17 approach that point, then just as before, they managed to re-contract to an efficient contract,
18 one would expect it then. But, if there was a prohibition on such re-contracting, there would
19 be these what I call end game effects. But, since there is not such a prohibition, then in any
20 world where those effects are material, there would be an incentive to re-negotiate.

21 Q One last point - and for this one I want to return to the equations -- I agree with you that if
22 this payment completion amount is exactly equal to the rental still due, then you reproduce
23 the ownership incentives. What I am interested in now is that we are talking about an
24 individual meter here. So, we want to know whether this contract is efficient for this
25 individual meter. You talk about the PRCs under the MSA contract. We are thinking here
26 of replacing in Year 12 or 13, or 14, or 15. Now, the PRC that will be due in Year 12 will
27 be dependent, for this particular meter, upon the proportion of the stock of meters that
28 existed as of January 2004 or 2003 - the original Legacy stock. That has been replaced by
29 Year 12. If a lot had been replaced you might be in the BLR band. If an awful lot have been
30 replaced you might be below the glidepath. If not many have been replaced you will be
31 above the glidepath. So, the actual price that you will pay - the PRC - will bear no
32 relationship at all to the age of this particular meter, it will just be related to the proportion
33 of stock that has been removed at that date - is that correct? A. The full details of how
34 the MSA contract works is a matter that has been studied in depth by my colleague,

1 Mr. Matthew, who you'll be able to cross-examine later. I have some understanding of this
2 matter, but basically it is true, I think, throughout that the rental in a sense is based on the
3 portfolio and does not depend upon the age the actual meter at 15 Acacia Avenue, so that is
4 correct.

5 Q So the PRC on this particular meter would bear no relationship to its age. It would just be
6 dependent upon what proportion of the stock had been taken up to date? A. Twelve years
7 down the line the PRC that has to be paid on my understanding of the contract is, if the
8 contract is 18 years old then for any National Grid meters that are still in place – of course
9 many may have been ripped out over the course of the 12 years – in year 12, then basically
10 the PRC that is paid on those is six years worth of rental, irrespective of the age of that
11 specific meter.

12 Q That is an averages statement. This particular meter might be 12 years old, it might be 15
13 years old, but the MSA terms are that the PRC payable is not related to whether it is 12 or
14 15 years old, it is related to how much of the existing stock has already been removed. Can
15 we have that confirmed?

16 MR. TURNER: Yes, that is correct, the assumption being of course the end of the term is likely
17 to be very, very short.

18 PROFESSOR STONEMAN: That is a different matter, the point is that the PRC is related to the
19 proportion of the stock that has actually been removed. Where I am going with this ----

20 MR. TURNER: I am sorry, I am reminded also to correct it by saying, and of course the
21 remaining term of commitment under the contract. It is how many you have taken out
22 relative to that term.

23 PROFESSOR STONEMAN: How many eighteenthths you have removed. It is completely
24 independent of the age of this particular meter? A. It's certainly independent of the age
25 of that particular meter.

26 Q The rental due is not independent of the age of this particular meter? A. The rental ----

27 Q The rental that you would have paid through to the end of the life of the meter? A. I
28 should give a health warning here that the issues of the aggregation into the aggregate
29 contract and how the blends work is, I think, in the testimony of Mr. Matthew.

30 Q I am not talking about the aggregate. You have given me a result based upon an example
31 relating to an individual meter. That example shows, and it is a very strong result if true,
32 that the incentives for that individual meter are exactly the same under ownership and under
33 a rental agreement with a PRC, and you did say in your evidence "any PRC", and what I am
34 saying to you is forget the averaging, does that result hold with an MSA where the PRC is

1 not related to the age of the meter but is related to the proportion of the population of meters
2 that has already been removed? A. I will try and answer this. As I understand it, but as I
3 say there are people who are closer to this than me so I want to caveat this much more than
4 anything else I've been saying over the last day, in a sense the MSA is what I would call a
5 giant payment completion scheme, that there is at the end of it a total amount of – ignoring
6 avoidable cost, there is a total amount of money that will be paid, NPV adjusted one way or
7 another. Therefore, at any moment in time, if one makes an adjustment to the number of
8 meters that you rent then basically it is designed such that the PRC that you pay is equal to
9 the reduction in rental commitments that you pay until the valid end of the contract – i.e. it
10 is my understanding that the contract is designed such that this is always true. I have not
11 studied all the details of the contract, and much of my belief here is actually from talking to
12 other people, so I do need to caveat my factual knowledge here. I believe that that is true,
13 that the total commitments just add up to a number if you ignore avoidable costs.

14 Q That may well be the case but that is not the evidence that you have given us. The evidence
15 you have given us relates to an individual meter. A. Yes, can I clarify. I have given
16 evidence that relates to an individual meter. If it's for a one meter population I think that
17 it's all nice and simple.

18 Q What is the result if there is a one meter population? What is the simple answer? You said
19 it is all nice and simple. What I am saying to you, if it is a one meter population and the
20 PRC is not age related, does it still reproduce the incentive structure that you have under
21 ownership? A. It's related to the remaining length of the – the PRC is related to the
22 remaining length of the contract.

23 Q Not if it is an MSA?

24 MR. TURNER: Sir, I will endeavour to clarify. The MSA is an agreement to rent a portfolio, a
25 whole group of meters. Every year there is a minimum scheduled number, so that goes
26 down every year, and the payment completion arrangements relate to that cohort getting
27 smaller every year. There is no agreement to rent any particular meter at all for any
28 particular term. So Dr. Williams is right to look at it on a global level, whatever his
29 example may have done by way of presentation of the point. I hope that helpful.

30 PROFESSOR STONEMAN: No, because the point here is that at the individual level the MSA
31 produces exactly the same incentives. This is the argument. A payment completion
32 contract reproduces exactly the same incentives as ownership.

33 MR. TURNER: That is right.

34 PROFESSOR STONEMAN: If it is an age related PRC then I would probably go along with that.

1 MR. TURNER: In the sense that it is coming down each year.

2 PROFESSOR STONEMAN: And I think Ofgem will go along with that as well because they
3 entered that into evidence.

4 MR. TURNER: There may be a ----

5 PROFESSOR STONEMAN: They did, I specifically asked, I said do you accept that an age
6 related PRC is non-abusive and they said, yes.

7 THE CHAIRMAN: Let us not get debate. We are asking questions of the witness at the moment.
8 You got to your feet to clarify the age of the contract.

9 MR. TURNER: Let us just clarify this.

10 PROFESSOR STONEMAN: The point is now is that the amount that has to be paid to get out of
11 the contract on this individual metering in year 12, bears no relation to how old that meter
12 is? A. It does bear a relation to how many more years of commitment you have on that
13 meter.

14 Q No, the amount that you have to pay on that PRC for that 12 year old meter depends upon
15 how many other meters have been cleared out?

16 THE CHAIRMAN: It might be free, you might not have to pay anything.

17 PROFESSOR STONEMAN: It might be free, yes.

18 THE CHAIRMAN: You might not have to pay any PRC.

19 MISS CARSS-FRISK: I am sorry, I just feel duty bound to state that Ofgem does not accept that
20 the analogy works for age-related PRCs either. I thought I should just flag that.

21 PROFESSOR STONEMAN: You do not accept that age-related PRCs are not abusive?

22 MISS CARSS-FRISK: Sorry, are analogous to ownership that the incentives are precisely the
23 same.

24 PROFESSOR STONEMAN: You did state, because I actually read it in the transcript, that you
25 do not consider age-related PRCs as abusive. I asked you specifically.

26 MISS CARSS-FRISK: Absolutely, yes, I am not going back on that all, it was just the ownership
27 analogy I thought I should clarify.

28 PROFESSOR STONEMAN: All I am trying to get at is that under MSAs the PRC you pay is not
29 related to the age of the meter that you are considering at the time. There is a future rental
30 commitment that is related to the age of the meter that you are looking at at the time, but the
31 PRC that you have to pay depends upon, for example, given how many meters you have
32 taken out previously, are you above or below the glidepath? That has nothing to do with the
33 age of the meter. That is all I am trying to say?

34 MR. TURNER: It is not the actual age of any particular meters, that is the point.

1 PROFESSOR STONEMAN: That is exactly what I am saying, it depends how many other
2 meters have been taken out relative to the glidepath.

3 MR. TURNER: But you can think of it then in terms, if you leave aside the actual ages of the
4 meters in the legacy group, you can think of it in terms of giving them contracted ages.

5 PROFESSOR STONEMAN: You may be able to set up a framework in the aggregate ----

6 MR. TURNER: Yes.

7 PROFESSOR STONEMAN: -- that gives you that result but that is not what we have in the
8 evidence. We have in the evidence here a statement that says that the level of the individual
9 meter, if the PRC is age related, which is basically what I argued, then we get an optimal
10 outcome, you get the same incentives as we get as if the meter is owned. What I am saying
11 is that the MSAs do not produce that result.

12 THE CHAIRMAN: Well can we let Dr. Williams now explain and comment on that? A. I
13 believe it is an issue about the aggregating up and the mixing effects and I am afraid that is
14 a territory which I do not feel qualified to comment on.

15 PROFESSOR STONEMAN: All right, with that I think I will finish. You are all agreed now we
16 should be shut in one room! (Laughter)

17 MR. TURNER: Professor Stoneman, if I might say, actually Mr. Matthew may be the right
18 expert to ask about this issue, because he is much closer to the mechanics of the MSA and
19 to this point.

20 PROFESSOR STONEMAN: The problem with that is that I cannot necessarily accept that Mr.
21 Matthew agrees with the evidence that Dr. Williams has put in on p.3123. He might say:
22 "Well that's Dr. Williams' issue and not mine."

23 THE CHAIRMAN: I have a couple of questions for you, Dr. Williams. Going back to the
24 question of market power, and the ability to price above the competitive level as an
25 indicator of dominance, you listed three factors, I think, which you say constrained the
26 ability to price above the competitive level on the part of National Grid, and one of those
27 was the price cap which has made its way into the P&M contracts. I do not know whether
28 you are aware that this Tribunal has, in a number of telecommunications' cases, considered
29 a similar question in which it has been expressed as relating to the "modified greenfield
30 approach", is that a term that you are familiar with at all? A. No, it is not.

31 Q Well perhaps I can summarise what it is and then see if you have any comment. What that
32 says is that when you are assessing market power you cannot take into account constraints
33 on the conduct of the putative dominant undertaking where those constraints arise because
34 the regulator has exercised a power to constrain that conduct when the precondition for

1 exercising that power is the existence of dominance, otherwise you get into a circular
2 argument. You say: “I am not dominant because I have had a price cap imposed on me, the
3 reason I had that price cap imposed on me was because I am dominant, and so you would
4 never get into the situation of the company being subject to regulation because the potential
5 for regulation would undermine the existence of the dominant position. Now, how do you
6 rely on the existence of the price cap, which I understand was imposed on National Grid
7 because it was a monopoly, is it right then to say because of that it cannot price above the
8 competitive level and therefore it does not have market power, when the existence of the
9 price cap is only there because it has market power? A. I think I understand what you are
10 saying. The first remark is I am giving economic evidence about whether or not they can
11 raise price, taking into account all the constraints they face. As I understand it what you are
12 saying is that from a legal point of view you might argue that one of these constraints might
13 not, from a legal point of view, be admissible as a constraint. Clearly, as an economist I can
14 just take constraints and say: “What effect do they have”, so in a sense I would, with
15 respect, want to pass that one back to you as your decision not my decision.
16 However, if one looks at what we are saying here, essentially the primary factor working
17 here was the threat of stranding that was forcing National Grid to make significant
18 concessions in order to retain the contracts. Now, of course, in the period it would take to
19 rip out the meters those gas suppliers would need to carry on renting meters and therefore in
20 that period of time presumably absent regulation National Grid can raise the price of those
21 meters possibly to quite a high level. However, I should point out that because of the
22 existence of the cap I did not perform – or feel the need to perform – this analysis. There is
23 then the question as to whether the speed of rip out is itself indigenous, i.e. if there were any
24 attempt to significantly raise those prices would there be any attempt to accelerate still
25 further the process. So it may still be that even if one took away that price cap, that the
26 eventual prices would still be below the regulatory price cap used now not as a market
27 constraint in the market but as a benchmark for the reasons I gave earlier.
28 So if one, for legal reasons, said one is not going to admit this constrain into the analysis
29 then at that point I would say that in order to prove that basically there was market power
30 somebody – and I have no idea whose burden this would be – would have to show that in
31 fact there would be the ability to raise price and that that would not induce any form of
32 supply response to accelerate still further. Does that answer your question?

1 Q Yes, thank you. The second point is that you say that the P&M contract creates this
2 artificial incentive for the gas suppliers to replace the meters in an inefficient manner,
3 because it does not include a payment completion provision? A. Yes.

4 Q We have seen in the evidence that when British Gas went out to tender for replacing the
5 meters, which was before the Legacy MSAs came into effect, they contemplated a 13, 14
6 year replacement programme. My question is whether you would have expected, given
7 what you have said was the artificial incentive created by the absence of a payment
8 completion term, whether you would have expected them to be a bit more ambitious than
9 that in wanting to replace the meters, or what factors do you think might have caused them
10 to be rather cautious about the rate of replacement? A. Obviously I cannot speak as to
11 what was in their mind, so it is a little bit difficult to say. What I do maintain is the
12 following, that if moving to a world of negotiating a contract against the background of the
13 P&Ms, then if British Gas want to extract the best possible price concession from National
14 Grid, it would be commercially rational for them to create a threat of replacement,
15 preferably as fast as possible, and as much uncertainty about “how fast as possible” in order
16 to extract the best concession. So, you have told me what they did at the early stages. What
17 I would say is relevant to the assessment of the situation at the time of the MSAs is, what
18 were they actually contemplating and/or threatening around that time. You know, whether
19 it’s five years or eight years, I’m not the person to judge that. But, that was the factual
20 matrix that I had in my mind, without taking a view on the five to eight when performing
21 my analysis.

22 Q Finally on this point about the new and replacement being a separate market from the
23 Legacy market, you have mentioned a couple of times something which struck me, which
24 was that the new and replacement threat, if I can call it that, has no mass in the sense that I
25 think you also put it that these potential threatening meters do not actually exist, but their
26 potential to exist is what asserts the competitive constraint on the conduct of National Grid.
27 You have had a debate with various counsel as to whether that means that they are in the
28 relevant market or outside the relevant market. You say that it does not really matter.
29 Nonetheless, the way that National Grid has put its case in the Notice of Appeal has been to
30 treat the new and replacement market as a separate relevant product market in which they
31 then give market share information. Because it includes all the contracts with the CMOs it
32 gives the rather different balance of market share from the Legacy meter market in which,
33 of course, National Grid has 97/98 percent. But, I wonder what your position is as to the
34 existence in fact, or as an essential element in National Grid of new and replacement meters

1 as a market rather than as a competitive constraint on the Legacy meter product? A. I am
2 struggling, I am afraid, slightly. I will offer some observations, but I'm not sure if they'll
3 directly answer your point. I am certainly saying that the shares that are provided of the
4 new and replacement market on my understanding - though I didn't personally perform the
5 calculations - is that in a sense you are adding up there how many meters are contracted to
6 be supplied. They may not yet have been supplied, but you add up how many contractual
7 promises are made. Now, of course one can always have an interesting debate about (a) in
8 general terms what is the relationship between market share and market power (if any); (b)
9 whether in those sort of contexts it might actually be that instead of the person with the high
10 market share having price-setting power, it's actually the person who sets the low price who
11 gets the high market share, i.e. the relationship between share and price might be the other
12 way round. Those are interesting questions which I don't think have been addressed by
13 Ofgem. But, what I am saying is that the reduction in the price of the MSA, which arose
14 from the threat of replacement -- The 'thing' that was doing the replacement threat is not
15 reflected in those numbers, i.e. something that was doing apparently several hundred
16 million pounds worth of competitive damage counts as a big -- You should almost add plus
17 zero to everything, but then realise that that zero is actually doing a lot of competitive work.
18 But, that zero, in a sense, almost by definition, is not in those numbers. I don't know if that
19 helps?

20 Q Yes, I think it does. Thank you.

21 Q Any re-examination, Mr. Turner?

22 Re-examined by Mr. TURNER

23 Q Dr. Williams, you were asked whether it is a necessary or relevant feature of significant
24 market power - or, to use the legal term, dominance - in the context of an alleged
25 exclusionary abuse that a firm could profitably raise prices above the competitive level. You
26 recall that debate. A. Yes.

27 Q Could you please be given Bundle A6. At Tab 20 you will find the recent guidance of the
28 European Commission. This is purely so that we can clarify your opinion.

29 MR. VAJDA: I think if this document is going to be put to the witness - and I have no objection
30 to it - it needs to be made clear what this document is. It is an enforcement priority from the
31 Commission.

32 MR. TURNER: This is the enforcement priorities of the Commission in applying Article 82 to
33 abusive exclusionary conduct by dominant undertakings. If you go to p.6 and look at para.
34 11 you will see an expression of view by the European Commission in the context of

1 exclusionary conduct. I would like to know whether you can clarify whether your view of
2 significant market power or dominance in an exclusionary context differs in any way from
3 this, and, if so, how. A. (After a pause): Well, the first sentence of it I surely agree
4 with. (After a pause): I think I broadly agree with this.

5 Q Thank you. If you drop down the page, while we are there, to para. 13, the Commission
6 states its view about the relevance of market shares in an analysis. Again, could you clarify
7 whether your view differs in any way from that, and, if so, how? A. (After a pause):
8 Right. On the first sentence it says, "Market shares provide a useful first indication --" I
9 probably would add a 'sometimes' there. But, then, of course, they move on to say,
10 "However, it will interpret market shares in the light of the relevant market
11 conditions - in particular the dynamics of the market and the extent to which
12 products are differentiated".

13 I might add that some other factors there should also be included, but broadly agree with
14 that. Then, in the third sentence,

15 "The trend or development of market shares over time may also be taken into
16 account in volatile or bidding markets".

17 Then I would agree. I mean, I always agree one should look at all the facts of the case, and
18 those are sometimes, possibly including this case, relevant facts that should be looked at..
19 So, basically I agree with that, yes.

20 MISS CARSS-FRISK: Madam, I am sorry. I am a little anxious that this is really straying into
21 adducing further material when the witness has actually expressed a clear view on matters
22 and it should not really be the opportunity to adduce further material in chief.

23 MR. TURNER: This is clarifying his view based upon what he had said and the questioning he
24 was given.

25 The second question: You were asked about whether the rental price that was agreed at the
26 time when National Grid struck the MSA terms in 2004 was at the competitive level. You
27 remember that debate. A. Yes.

28 Q There was an assumption that National Grid's price to some extent is lying above the
29 corresponding CMO price for replacement meters at that time. You remember that? A.
30 It was put to me -- Somebody put to me a sort of factual claim that the National Grid price
31 was above the CMO price. I think, if my memory is correct, the transcript will say that I
32 though there was some debate there and I didn't know absolutely the factual answer.

1 Q Now, you remember also that the questioning extended to the relationship between the
2 amount of payment completion and the level of the rentals that were being required by
3 National Grid, the relationship between the exit charge and the rental? A. Yes.

4 Q Could you pick up Ofgem's skeleton at para.113, which should be in CB2, tab 15. Do you
5 have that? A. This is the skeleton of Ofgem, yes.

6 Q Could you go to p.39, para.113. Could you read that to yourself. A. (After a pause) Yes,
7 I've read it.

8 Q Can you clarify any further what you were saying previously in answer to those questions
9 about your view on the appropriateness of either the level or the structure of the PRCs under
10 the Legacy MSAs? A. Could you repeat the question, please?

11 Q Having read the proposition which is set out there about the level of the rental payments ----
12 MISS CARSS-FRISK: I am so sorry, madam, again I do not believe that this witness was asked
13 about this.

14 THE CHAIRMAN: Your point is that this is not excessive pricing case, and it is not part of
15 Ofgem's case that the PRCs overall were set too high – is that your point?

16 MR. TURNER: He was questioned about the relationship between the rental charge and the level
17 of the PRCs, and the question was whether, if the rental charge is accepted to be non-
18 excessive, this has any implications for either the appropriateness of the level or the
19 structure of the PRCs?

20 THE CHAIRMAN: I think the comparison was being made between the rental charge under the
21 Legacy MSA and the rental charge under the CMO contracts.

22 MISS CARSS-FRISK: Yes.

23 THE CHAIRMAN: And what you are saying is, well, you cannot rely on that as evidence of an
24 ability to price appreciably above the competitive level because that is not part of this case.
25 Is that the point?

26 MR. TURNER: That is the point I am trying to ask the witness for his views on, madam.

27 MR. VAJDA: (without microphone) ... not to lead the witness.

28 MR. TURNER: This is not leading the witness, this is asking him an open question by reference
29 to a document.

30 MR. VAJDA: I think this debate means that the value of any re-examination is going to be very
31 minimal on this point.

32 MR. TURNER: I am in your hands, madam, about that.

1 THE CHAIRMAN: I think this can be dealt with by submission. We have Dr. Williams' in
2 respect of that and I understand where you are going but I am not sure it is something that
3 he can help us with further.

4 MR. TURNER: Yes, madam. One final question, madam. (To the witness) The Chairman
5 asked you a question about the situation in which, although there may be payment
6 completion arrangements in place which last 18 years, the meters might still continue in
7 place and being rented for some period after that. A. Yes.

8 Q Can you clarify any further your view of whether that possibility affects the payment
9 completion and pricing equation which you had been referring to in your evidence and its
10 implications? A. I have always thought of this analysis in terms of payment completion
11 over the period of the MSA contract, and it has always been my belief that at the end of the
12 MSA contract one simply renegotiates. If there is a term in the contract enabling one to
13 extend, that is an option for the buyer, but not an obligation, and one would just see what
14 would happen at that point. I think that is the only extent to which I could possibly clarify.

15 MR. TURNER: I have no further questions.

16 THE CHAIRMAN: Thank you very much, Dr. Williams, I can release you from the witness box.

17 (The witness withdraw)

18 MR. TURNER: Madam, our next and final witness is Mr. David Matthew.

19 THE CHAIRMAN: I think we had better make a start on Mr. Matthew.

20 MR. TURNER: I respectfully agree.

21 THE CHAIRMAN: Although I appreciate that means that he will be in purdah over the week-
22 end. Is that going to present you with insuperable difficulties?

23 MR. TURNER: It should not do, madam. However, before the Tribunal enters a break this
24 afternoon we did have some initial words about closing submissions. With the Tribunal's
25 permission – and my friends will say if they agree or not – it may be helpful if the Tribunal
26 were to rise for five minutes at some point for us to discuss what our proposals would be in
27 relation to that next week.

28 THE CHAIRMAN: That we rise for five minutes next week some time!

29 MR. TURNER: No, rise for five minutes before close of proceedings today.

30 THE CHAIRMAN: Why do we not do that now and come back at just gone 3.30.

31 (Short break)

32 THE CHAIRMAN: Mr. Turner?

33 MR. TURNER: I am very grateful. There are essentially two issues. The first is when we kick
34 off after the experts finish. The likelihood is that the experts are going now to soak up

1 most, if not all, of Monday and the question then is whether we go straight into closing
2 submissions before you, or whether there is a breather for a day given the indication that the
3 Tribunal may be prepared to sit until Thursday. Mr. Vajda is the counsel for whom that is
4 inconvenient, the rest of counsel can and would prefer a day's breather to assemble
5 everything and then have two days on Wednesday and Thursday.

6 The second question is one of structure of closings. All parties agree that National Grid as
7 the appellant have the last word. We favour a structure which has been followed in previous
8 such cases where we have our submissions first, they answer, and we have a short reply at
9 the end.

10 What is favoured on all sides apart from National Grid is that they kick off and have a day
11 between themselves – we do not therefore start with any closing submissions, and we
12 follow that for a day, and that concludes the oral proceedings. So those are the two issues
13 for the Tribunal and I have, I hope, summarised that accurately on behalf of all counsel, but
14 we are in your hands on those questions.

15 THE CHAIRMAN: Mr. Vajda, are you not available on Thursday, is that the problem?

16 MR. VAJDA: I am, in fact, due to be in Copenhagen on Thursday, but it is only affecting me, but
17 I just mention it, the Tribunal has to take an overall view and not just look at my position.
18 For that reason I am not in a position to consent to a day – we for our part would be happy
19 to do it without a break, but that is only my own personal position. I am not in any way
20 saying that it should determine the view of the Tribunal, there it is, and I do not think I can
21 say much more about it.

22 THE CHAIRMAN: But if we took the break on the Tuesday, then on either structure, as regards
23 closing submissions you are unlikely to be heard on the Wednesday?

24 MR. VAJDA: I would be here on Wednesday. I had anticipated that the trial would finish, as
25 indicated, on Wednesday, but I fully accept for all sorts of reasons it has taken longer and,
26 as I say, it is simply my position; the Tribunal has to look at the position of everybody and
27 so I am not saying it should be just done for my convenience at all, but I just mention that
28 because that is why I am not able to accede to the suggestion made by Mr. Turner. I also
29 accept that if, in fact, we have a break, and it may be that we go into Thursday whether we
30 have a break or do not have a break, I can see that there is a risk of that as well.

31 THE CHAIRMAN: This may become academic depending on how we get on with our witnesses
32 between now and then. Miss Carss-Frisk, do you have anything that you want to add to
33 that?

1 MISS CARSS-FRISK: As Mr. Turner has indicated, we are certainly happy and indeed think it is
2 a good idea if we can to have a break for people to put together their closing submissions as
3 efficiently as possible. If we do have that – particularly if we do have that – it seems to us
4 the most sensible course is then for us to go first followed by the interveners, and then for
5 Mr. Turner to have the last word. It seems to us that in the two days we are likely to have it
6 is not really going to work, and it is going to be inefficient to have Mr. Turner, then us, the
7 interveners and then him again and frankly it also seems to us that that does give him rather
8 too many bites at the cherry, given that way we have started, etc.

9 THE CHAIRMAN: Well he is the appellant, but it may be that if we were to go with your
10 structure where you go first and then the other parties make their submissions it may be that
11 we would run out of time if we had the break even sitting on the Thursday. I know in the
12 past the Tribunal has then asked for submissions in writing, but that creates its own
13 difficulties.

14 MR. TURNER: Yes, the way that my structure would work would be that instead of a day for
15 them a day for us, we would go until, say, 3 o'clock on the Wednesday, they would go until
16 3 o'clock on the Thursday and we would have then time for a short oral reply to close things
17 on the Thursday.

18 THE CHAIRMAN: I will think further about this over the weekend. Yes, Mr. Vajda?

19 MR. VAJDA: I have addressed you, madam, on my personal difficulties, I have not addressed
20 you on the other point and I would just stress that I support the position of Ofgem, because
21 the way that this has been done has been different from a normal High Court trial, the way
22 that one had factual witnesses together and one is going to have expert witnesses together,
23 and therefore it seems to me in terms of economy and, dare I say, the cost of these
24 proceedings it is much better that we just go Ofgem, us and Mr. Turner last.

25 THE CHAIRMAN: Let us crack on for the rest of this afternoon.

26 MR. TURNER: Our final witness is Mr. David Matthew of NERA.

27 Mr. DAVID MATTHEW, Sworn

28 Examined by Mr. TURNER

29 Q Mr. Matthew, do you have a bundle marked WS1? A. Yes.

30 Q Turn to Tab 5. On the first page, numbered p.905 do you see a document entitled
31 'Comparison of Contract Structures - Legacy MSA and Age-Related PRCs'. A. I do.

32 Q Would you turn on in that document to the final page, p.969? Is that your signature on that
33 page? A. It is.

34 Q Above that, is that your expert declaration. A. It is.

1 Q Does the preceding document represent your first expert report in these proceedings? A.
2 Yes, it does.

3 Q Would you turn next to Bundle WS6? In WS6 would you please turn to the third tab,
4 marked Tab 24? Look at the first page bearing the number 3489. Do you have that? A. I
5 do.

6 Q Do you see there a document entitled ‘Comparison of Contract Structures - Legacy MSA
7 and Age-Related PRCs - Second Report of David Matthew’? A. Yes.

8 Q If you turn on in that document to p.3534, is that a copy of your signature? A. Yes.

9 Q Above that is that your expert declaration? A. Yes.

10 Q Is this your second expert report in these proceedings? A. Yes, it is.

11 Q Mr. Matthew, if you wait there, other counsel will have questions for you.

12 Cross-examined by Miss CARSS-FRISK

13 Q Mr. Matthew, focusing on your first statement for a moment, at para. 14 on p.915 you say
14 that:

15 “Under certain assumptions the costs of early replacement under the two contract
16 structures will be precisely the same. Relaxing these assumptions loses the
17 precise equivalence, but not the general thrust of the analysis or the conclusions”.

18 Now, that is talking about the various stylised examples that you give in that report, is it
19 not? A. Yes, it is.

20 Q Yes. As you say there, you are demonstrating that it is possible to construct replacement
21 scenarios whereby the total cost of replacement is the same under the MSA or an MSA-type
22 structure and an age-related-type structure. A. Well, I think what I’m saying is that
23 because early replacement under the two structures will be pretty much the same in a very
24 wide range of circumstances, I recognise that there is not precise equivalence and that there
25 are some circumstances where the equivalence will not alter.

26 Q You make a number of assumptions, as you have said, in para. 14. You set those out in
27 paras. 37 to 39, do you not? Is that right? That sets out the assumptions that you make. A.
28 Yes. Paragraphs 37 to 39 set out my slightly simplified versions of an MSA-type contract
29 and what I think of as an individual meter-based contract.

30 Q In particular, as one sees from para. 39(a), for an age-related contract you assume that PRCs
31 will always be paid on replacement regardless of the reason for replacement, i.e. including,
32 for example, replacement of a faulty meter. A. Well, perhaps I should explain ----

33 Q If you do not mind, is the answer ‘Yes’ or ‘No’ to my question? A. Well, you’ll have to
34 ask the question again.

1 Q Is it right that looking at the age-related approach you do not draw any distinction between
2 the reasons why a meter is replaced? A. I abstract from it.

3 Q Yes. That is really what you say in para. 39(a). Yes. Overall, in your stylised examples,
4 you do not distinguish between what Mr. Keyworth has referred to as non-discretionary
5 replacements - those that have to be done, for example, faulty meters - and other
6 replacements that he calls discretionary replacements. A. No. This stylised example
7 essentially treats all replacements as, sort of, one group. So, it doesn't distinguish between
8 the free replacements are free because they are faulty, policy, or functionality exchanges, or
9 free because they happen to have reached a pre-specified age benchmark.

10 Q But in fact, and I am sure you would acknowledge, the age-related counterfactual used in
11 the Decision, which is based on the CMO and new and replacement-type contract, does
12 have the feature that no PRC is payment for faulty meters. A. It does, and so does my
13 stylised example.

14 Q These stylised examples that we looked at in your first report do not draw any distinction
15 between non-discretionary and discretionary replacements, as you have said. A. No.
16 What they are doing is they're saying in the particular way I've set out my population here,
17 is that this is a twenty-year contract. It has a glidepath for the MSA version. So, it's going to
18 allow -- It starts off with 2 million meters, but then allows 100,000 replacements each year.
19 So, you reach zero at the end of the glidepath. What I have done is I've tried to build up,
20 call it an age-related contract -- what I mean is a contract where each meter has an
21 individual contracted life. I've tried to build that up in such a way that, in aggregate, the
22 number of meters that you have contracted to rent in each period is the same as that implied
23 by the glidepath.

24 Now, to achieve that the age-related contract will need also to allow for 100,000 free
25 replacements in each year because that is what the glidepath contract does. Now, in
26 practice, that 100,00 would need to be built up of faults -- functionality exchanges, policy
27 replacements and whatever we have specified as our free replacements by virtue of their
28 age. Now, my stylised example doesn't break it down in that way. It just simply says,
29 "I'm going to assume that we know which 100,000 meters would reach the end of their
30 lives for any of those four reasons at each point in time, and that we have an individual
31 contract linked to each of those meters". So, it doesn't separate out the different reasons
32 why meters become free. But, the example is clearly intended to encompass that possible
33 complication.

1 Q Yes. But, it is not actually set out. I understand what you are saying, but it is not actually
2 acknowledged in the examples as such, because, as you say explicitly at para. 39(a), you do
3 not draw a distinction. A. I think that's what para. 39(a) says - it says I do not draw a
4 distinction. I believe I wrote it, and I believe it's clearly implied that what I have just
5 described is precisely what I'm doing.

6 Q So, what we get, as I think you acknowledged right at the outset of me asking you questions
7 is that you are able to construct scenarios in which the total replacement costs are the same,
8 but of course they do rest on certain assumptions being made? A. To go back to the
9 conclusions, the conclusions of the analysis are that, and admittedly these are stylised
10 examples, the costs of early replacements are the same under both contract structures across
11 a very wide range of replacement scenarios. It says there are some wrinkles in that and that
12 there ware scenarios where that won't be cheap. For the most part, it's suggesting they are
13 essentially equivalents.

14 Q In the worked examples that you give? A. Yes.

15 Q Going back to this point about not drawing distinction between discretionary and non-
16 discretionary replacements, of course Mr. Keyworth's analysis very much focuses on the
17 cost of the discretionary additional replacements that can be made, as you accept, I think?
18 A. Yes, that's a key theme in his report.

19 Q As you note in para.92 of your second report – you may just want to have that open, WS6,
20 p.3523 – you refer to Mr. Keyworth's calculations and in the last sentence of para.92 you
21 say:

22 “These figures assume that the Gas Supplier has to undertake 850,000 non-
23 discretionary replacements every year, and that these 850,000 are not brought
24 forward from future years to the early years.”

25 So you are referring to his estimate there of non-discretionary replacements? A. Yes.

26 Q Here there is a degree of dispute, as I understand it, between you and Mr. Keyworth as to
27 the reasonableness of that assumption – is that right? A. On the 850,000?

28 Q Yes, as to that level of non-discretionary replacement? A. There is a factual question
29 about whether, in the context of his contracts, 850,000 is a reliable number. I think the
30 disputes – I think I'd probably stretch to even call it a dispute – the disagreements between
31 myself and Mr. Keyworth on that point is of third order relevance to the principal
32 differences between our reports. The principal differences between our reports relate to the
33 basic methodology one should use if you're trying to ----

1 THE CHAIRMAN: Just focus on this 850,000, rather than how important a dispute it is, or
2 disagreement. Let us just focus on that.

3 MISS CARSS-FRISK: Thank you, madam. We will just spend, if I may, a little while on this
4 third order dispute. First of all, I am sure you would accept that, of course, there will have
5 to be some non-discretionary replacements in the years going forward? A. Yes, and I
6 would generally expect them to be fairly substantial.

7 Q Fairly substantial, yes. Of course, the particular relevance of the non-discretionary
8 replacements is that they reduce the number of additional replacements that can be made
9 free under the glide path under the MSAs? A. The glide path allows 980,000 free
10 replacements each year, and the assumption of Ofgem, and I think it is a reasonable one, is
11 that gas suppliers use that allowance to undertake their non-discretionary replacements. So
12 simple subtraction tells you that if you have agreed to be able to replace 980,000 meters a
13 year for free, of which 850,000 are non-discretionary, that leaves 130,000 that are
14 discretionary.

15 Q One of the points you have made is that National Grid intends to change its policy as to
16 non-discretionary replacements. Is that not right? A. That's what I understand to be the
17 case.

18 Q If we look at para.98 of your second statement, please, p.3524, you say:

19 "Indeed National Grid is moving to an output based approach for policy
20 replacement and I understand that for a period, policy replacement obligations will
21 be well below the Maximum Replacement Number. This would reduce the volume
22 of non-discretionary replacements required and therefore increase flexibility for
23 meter operators to be increase replacement in one year and reduce it in the next.
24 While this may not have been anticipated in the earlier years, as discussed in
25 Section 7.1, it is unclear how realistic a much larger output expansion would have
26 been in the earliest years of the contract."

27 You are not in a position, as I understand it, to give factual evidence as to that new policy
28 that may or may not come into effect, or indeed have come into effect? A. No, I am not.

29 Q But what you do acknowledge in para.98 is that this may not have been anticipated in the
30 earlier years – i.e. even if there is such a new policy, you appreciate that may not have been
31 anticipated by the gas suppliers? A. I actually don't know whether they did or didn't
32 anticipate it, but I have no reason to suppose they did anticipate it.

33 Q It is reasonable to think, is it not, if you were to evaluate your possible replacement
34 decisions shortly after you have signed the MSAs, just imagine this position, it is reasonable

1 for you to simply work on the basis of the contract, is it not, and what you know about
2 policy replacement at that point, and not anticipate a possible change in the future?

3 A. Well, as you pointed out, I am not a witness of fact on what gas suppliers did or did
4 expect at that time. The observation I make on the assumption that Ofgem draw, which is
5 they assume that gas suppliers expected there always to be 850,000 meters each year – as I
6 stress, I don't regard this as a central issue – they make that assumption on the basis of an
7 inference as to what they think gas suppliers would have expected. I have no knowledge
8 myself at all as to what they did expect, but in terms of the evidence for that factual
9 proposition, what Ofgem thought gas suppliers expected seems to me to be fairly weak – in
10 fact, I would have asked them, "What did you expect?" and got some answers.

11 Q When you say what Ofgem expected that the gas suppliers would do, you mean what
12 exactly? A. I mean that the factual basis for Ofgem's view that there will always be
13 850,000 non-discretionary meters, and also Mr. Keyworth's calculations of assumption of
14 those parts, the factual basis for that seems to be Ofgem's inferences as to what they
15 thought gas suppliers expected, not facts what gas suppliers actually did expect.

16 Q You do not dispute, as I understand it, certainly not based on your report, Mr. Keyworth's
17 explanation and evidence as to what he knows about what actually happened in the first
18 three years of the contract where that sort of level of non-discretionary replacement took
19 place? A. Sorry, could you repeat the question?

20 Q Mr. Keyworth explains in his statement about the level of replacement that took place in the
21 first three years of the contract, and he gets to about 850,000 a year – yes? A. Yes.

22 Q And he provides a basis for getting to that figure? A. Yes.

23 Q You do not quarrel, as I understand it, with how he derives the figures he gets for the first
24 three years based on what actually happened? A. The figures for his assumptions as to
25 how many non-discretionary replacements were either obligated upon or decided to do by
26 gas suppliers in that period?

27 Q Yes. A. No, I don't dispute that.

28 Q You do not dispute that. So the only dispute then is as to whether it is reasonable to
29 consider that those sorts of replacements would continue at roughly that sort of level in the
30 future? A. In respect of the assumption that the 850,000 figure or thereabouts would
31 continue for the whole life of the contract, yes, that is the question I raise.

32 Q That is the question you raise. Now, one possibility you raise in your statement is as to
33 advancing the following years' non-discretionary replacements into an earlier year and thus

1 gain a glidepath advantage, if you like, in that way. That is right is it not? A. Sorry,
2 which particular ----

3 Q It is paragraph 93 of your second report, p.3523.

4 “If it is assumed that gas suppliers could advance next year policy non-discretionary
5 replacements when they accelerate replacement, that would imply a much lower
6 ‘marginal cost’ (using Mr. Keyworth’s metric) under the Legacy MSA than the
7 figures that he presents.”

8 A. Yes, this is the point that Mr. Keyworth says we are going to allow for 980,000
9 replacements each year, but 850,000 of them will be non-discretionary, leaving 130,000
10 discretionary. So he works out, and I have no quarrel with his calculations that if you do a
11 substantial increase in discretionary replacement early on, and then continue to undertake
12 850,000 replacements afterwards, then the earlier replacement charges you end up paying
13 start to mount up. I have no difficulty with the calculations that he has undertaken there. I
14 think what he has in mind is if you were to accelerate those replacements in that early
15 period, but then cut back by even more than going back down to 850,000, so the gas
16 supplier assumes to possibly want to go right down to zero, you cannot do that under the
17 MSA, because you always have to do this 850,000 – I think this is a slightly academic
18 debate anyway, because it is not clear to me why you would want to go shooting up in three
19 years and come down to zero in later years.

20 Q Mr. Matthew, my question was related to your para. 93? A. Yes, so this paragraph is
21 going to the question of in the rather unlikely circumstances that gas suppliers would
22 actually want to do that, one way in principle that they might be able to do it is rather than
23 bringing forward future discretionary replacements, they actually bring forward next year’s
24 non-discretionary replacements. So they might try and do all of next year’s non-
25 discretionary this year, and then hugely slash back their replacement next year to get back to
26 the glidepath. Using his metric for paraphrasing what he calls “marginal cost” that would
27 give you a lower number.

28 Q You accept, I think, judging by your footnote 70 that there is no provision in the contract for
29 this to happen. That is p.3524? A. Yes, so the observation by Mr. Keyworth is that
30 under the MSA you have a policy pool effectively, and you also have an obligation to
31 undertake replacements each year, which is the replacement number and that replacement
32 number is subject to a maximum, so effectively it caps the gas suppliers’ exposure to having
33 to do loads and loads of policy replacements out of their glidepath allowance.

1 What I think Mr. Keyworth's point is, is that if you shoot up policy replacements this year
2 you cannot stop your policy replacements next year because the maximum replacement
3 number, as set out in the contract, does not have a provision to go below the number it
4 would have been merely because you went over it in the previous year. That, so long as the
5 maximum placement number is always binding, which is a factual question as to whether it
6 actually would, could have the property that you end up not being able to bring forward
7 next year's non-discretionary replacements in, as I said, the rather unlikely circumstances
8 that you might want to do that. My observation is simply that if that is the factual position
9 then what he says is potentially right. National Grid says it is not the situation. I agree with
10 Dr. Williams that it is not on the face of the contract ----

11 Q You agreed, first of all, I think, with my original question that there is no provision so far as
12 you know in the contract for this to happen? A. As far as I understand the contracts there
13 is no provision for it, National Grid, I understand, relies on wider obligations to say in the
14 event that somebody really did shoot up policy replacement in one year they would be
15 obligated, or would otherwise in any event allow them to cut back next year.

16 Q You say in footnote 70 that National Grid has said that it would in fact allow this, but what
17 is your evidence for that that National Grid has said so? A. Well I thought they had said
18 that, I am sorry, I did not provide a reference, but I thought they had put it in.

19 Q You thought that they had said it, to whom, when ---- A. In their submissions in this
20 proceeding.

21 Q That is the sole basis for your evidence here, that you thought they had said it somewhere in
22 these proceedings? A. Well I probably could find the reference if I had a bit more time,
23 but I am reasonably confident that they have made submissions in these proceedings saying
24 that that is what they would do.

25 Q Simply in these proceedings that is all – no other communication? A. I am not aware of
26 any other communications. I am, I think this is right, aware – at least I believe it is the case
27 – to date anyway, in relation to policy replacements, which is the variable that affects this
28 matter, the problem that British Gas has faced ,and apparently they are the only ones in the
29 frame where this might have an influence, has been that their CMOs have had a lot of
30 difficulty undertaking the policy replacements that they have been obligated to do up to
31 now and, in fact, the problem has been how are they going to do the number that they are
32 supposed to be doing? So in that context, and I do not know if it is the right context (but I
33 believe that to be a fair characterisation of what has actually been going on) it does not
34 surprise me that the matter of whether if British Gas were to do a much bigger replacement

1 of policy meters would they be allowed to then cut back next year, does not seem likely to
2 have arisen so far.

3 Q No, so far as you know it has not happened in practice? A. No.

4 Q And it would be reasonable for someone evaluating the contractual situation to work on the
5 basis of the contract, what the contract provides? A. I do not think that is necessarily
6 true. I think if I were to look at whether the absence on the face of the contract of provision
7 for this particular mechanism to work was likely to have a significant effect in practice, (i) I
8 would like to know first, is this sort of scenario quite realistic; and (ii) in the time frame we
9 are actually talking about, is there evidence to suggest that it might have happened if it had
10 been clear, and if you have got past that stage and said yes, it potentially would be relevant I
11 think I would have raised the matter in more depth with National Grid and other parties to
12 the contract to ask “Did people ask for it?” “Did they ask for a change?” “Was it refused”.
13 But the fact that it is not explicitly written in a contract does not amount to ----

14 Q If you just signed up to the contract you would be likely to say “This is the contract, what
15 does it say? This is what governs my rights”, would you not? A. Well I am not a witness
16 of fact as to what it is to be a gas supplier, but my guess would be that if I was a gas
17 supplier signing up to this contract and I anticipated that I might want to do substantially
18 more non-discretionary replacements than 850,000 and then to want to cut back by a very
19 substantial amount so that I could get back to the glidepath in the next period, I would
20 probably note the contract does not provide for this, and I would probably approach
21 National Grid and say their contract does not provide for this. It’s clearly not the spirit of
22 the contract that I should be denied the option to do this. Can we come to some kind of
23 arrangement that clarifies this?” So, I don’t think the fact that it’s absent from the contract
24 would necessarily be where I’d stop if I was manager of such a business. But, I am not a
25 manager of such a business. So, I can’t be absolutely certain of this.

26 Q Turning to what I suspect you believe is a major issue between you - revenue neutrality -
27 that is, between you and Mr. Keyworth - and looking, please, at paras. 6 and 7 of your
28 second report, at para. 6 on p.3494 you say,

29 “I understand that the case being advanced by Ofgem is that the structure of the
30 Legacy MSA is contrary to competition law because it has a foreclosing effect”.

31 Then, at the beginning of para. 7,

32 “If Ofgem’s objections are against the structure, but not against the level of
33 revenue recovered under the Legacy MSA, it follows that in order to evaluate

1 whether the structure does indeed have a foreclosing effect the agreement must be
2 judged against a counterfactual which is revenue neutral”.

3 So, if the case is based on structure, then any counterfactual, you say, must be revenue
4 neutral. A. Yes. I think that’s a necessary, but not sufficient, condition.

5 Q But, if, in fact, the case is not simply about structure, but about considering the overall of
6 the specific contracts here - the MSAs - if it is not just a structural comparison - then your
7 objection goes away, does it not? A. Well, my reports and testimony are about the
8 structure of the contracts. If there is some other basis for objection to the contracts, that is
9 not something that I’m attesting to. I’m merely saying that if the objection is the particular
10 way the MSAs are structured - so, the use of the BLRs, the glidepath, and the average PRCs
11 -- if that is the objection I don’t believe that objection to be valid because I don’t believe
12 there is much difference between that structure and an individual meter contract structure.
13 If there are other objections, then my report doesn’t really go to those issues.

14 Q So, if it is looking rather broadly at the particular contract here - not simply structure - then
15 there is no problem (to put it that way) about a counterfactual that is not precisely revenue
16 neutral. A. Well, I can’t answer that question because my analysis of the counterfactual
17 is related to structure as being the issue. If there are other issues, such as -- I don’t know.
18 Suppose the issue was simply that Ofgem alleged that the glidepath just simply didn’t allow
19 for a large enough volume of replacements, and so the claim was that it just should have
20 been a larger number - 1.2 million not 980,000 on the ground that that would have helped
21 CMOs, for example. My observation would be, “Well, I don’t see what basis you have to
22 say that, but if that’s the nature of the objection, all this stuff about an age-related contract
23 being different from the MSA is not where you should start”. It may be said, “Well, okay.
24 Let’s adjust our MSA. Give it a bigger glidepath -- a shorter glidepath -- a bigger allowance
25 and start from that point. Then if there’s an age-related contract it can be related to that
26 volume agreement over time”. So, my testimony really can’t go beyond the matter of
27 contract structure.

28 Q Yes. Just to be absolutely clear then, I think it follows that if we get away from the purely
29 structural comparison then what you say about value neutrality also is not really relevant.
30 A. Well, as I say, my analysis is going to the matter of contract structure. I understand the
31 objection to be contract structure. To the extent that that is the objection, My analysis says
32 that that objection is not well-founded. To the extent that there are other objections, well,
33 my testimony doesn’t go to those. I’m somewhat surprised that they’re not rather more
34 prominent in Ofgem’s case as put so far.

1 Q Mr. Matthew, it may or may not surprise you that those are my questions.

2 (The Tribunal confer)

3 THE CHAIRMAN: Mr. Matthew, we do have some questions for you from the panel, but we do
4 not want to do those now. We will hold those over until Monday morning. But, we do want
5 to decide now about the points on the submissions so that you know where we stand as we
6 go into the weekend. So, we will rise and discuss that amongst ourselves if I could ask you
7 to stay here until we are ready to tell you what the answer is, which I hope will not be
8 terribly long. We will tell you what the plan is, but we will not be asking you any more
9 questions this afternoon.

10 MR. TURNER: I am obliged, madam.

11 (Short break)

12 THE CHAIRMAN: What we have decided about closing submissions is as follows: Although we
13 mentioned that we were prepared to sit on the Thursday if the case had not finished by then,
14 that is not actually entirely convenient for the members of the panel. So, unless it is
15 absolutely necessary we do not wish to sit on the Thursday. That means that we will not be
16 taking a break, although certainly if we make good progress on Monday with the witnesses
17 and finish before the close of play, then we will finish early and we will not move straight
18 to closing submissions. However, we do want to hear closing submissions on the Tuesday
19 and Wednesday.

20 We do not see any reason to depart from the usual practice of appellant's closing
21 submissions, respondent and then any short reply unless it is agreed between the parties that
22 we should move to a different pattern of submissions. I do not know, Mr. Turner, whether,
23 now that there is not going to be a break, you would prefer to move to a different pattern,
24 but you can discuss that amongst yourselves.

25 MR. TURNER: It does mean that we move straight from cross-examining directly into closing
26 submissions, and so I would appreciate a little moment to think about that.

27 THE CHAIRMAN: Yes. Does anyone else have anything to say?

28 MISS CARSS-FRISK: No, that is clear, madam. What you have directed is that we stop, at
29 whatever time that may be, after cross-examination finishes on Monday and then start on
30 Tuesday with Mr. Turner going first.

31 THE CHAIRMAN: If that is what Mr. Turner wants to do. But, we will leave that to him to
32 consider further.

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34

1 The only other thing I can say is that we certainly cannot finish later than four o'clock on
2 Monday. We will start at ten-thirty on Monday morning, continuing with Mr. Matthew.

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4 (Adjourned until 10.30 a.m on Monday, 25th January, 2009)
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