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IN THE COMPETITION APPEAL TRIBUNAL

Case No. 1099/1/2/08

Victoria House,
Bloomsbury Place,
London WC1A 2EB

29th 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 11)

APPEARANCES

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

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

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

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

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

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THE CHAIRMAN: Good morning.

MR. TURNER: Madam chairman, we will have a written closing document to hand up but the photocopier has melted down, and so that will be produced hopefully very shortly, but if I may kick off in any event.

I will not begin by saying to the Tribunal that this is a simple case. You have heard many days of submissions and evidence. At the end of the day your task is going to be take Ofgem's Decision in CB1, you have to examine its process of reasoning, the quality of the evidence that it relies on and its conclusions, and then finally you will decide whether, on that basis, it should be confirmed or set aside, and whether to exercise any of the specific powers that you have in para. 3 of schedule 8 to the Act. The object of your exercise is not to scrutinise these contracts and their design to see if they are optimal for achieving some social efficiency or for achieving a particular market outcome that the Regulator might want to achieve at this point in time, such as clearing away costs to make way for a Government mandated "smart" programme and if not then to nullify these contracts as a matter of law, which would be the effect, or could be the effect of your decision.

I would ask you to begin by focusing once again upon the operative part of the Decision, if you would pick that up in CB1, tab 1, p.130. We remind ourselves when we look at para.1, that the vice which is identified relates to the Legacy MSAs, this was established in the openings. The central task now for you is to decide whether Ofgem's Decision cogently establishes first that National Grid was in a position of significant market power in the context of the Legacy MSA negotiations, which is where the point really arises, and then if you do find that, that National Grid crossed a line between legitimate and abusive behaviour by including in the Legacy MSAs these features to which objection is taken.

As a footnote, the absence of a separate maintenance charge in the rental is, as you know, not alleged to be a distinct abuse. Ofgem's position, which is set out very clearly, is that in the absence of the other factors the requirement to take maintenance from National Grid alone – and I quote the Decision at 4.85 and 4.182: "would not appreciably restrict competition." So I do not dismiss maintenance on that account but when you read the operative part of the Decision you have to place that in its correct perspective.

To show that the line between lawful and abusive behaviour was crossed does require a benchmark of some kind. Ofgem has to show that these features in the Legacy MSAs involved in the language of the classic *Hoffmann-La Roche* case: recourse to methods different from those which condition normal competition and that they thereby foreclosed

competition" in the true sense of anti-competitive foreclosure, and thereby can be expected to have harmed consumers.

Whilst some of the issues in this case have undoubtedly become clearer as this hearing has progressed there remains in our submission a fog of confusion about what Ofgem sees as its essential test for abusive or foreclosing behaviour, because in the course of the hearing it appears to ride several horses at once, and to illustrate this I return to my remarks in the opening submissions concerning the absence in the Decision of findings that the Legacy MSA structure, or charges restricts competition in relation to PPMs (prepayment meters). To reiterate the points, Ofgem's Decision acknowledges quite correctly that for PPMs you have the much shorter glidepath, seven years – there was a 10 year, if you like, expected life – as opposed to 18 in the case of the DCMs, with steeply falling PRCs at each year of that arrangement; and they say that the PRCs are smaller in relation to the costs of purchasing and installing new PPMs. Ofgem refers to those features and then it does not find foreclosure to have occurred as respects PPMs in its reasoning unless there is a future re-balancing of the DCM/PPM charges, which is the caveat it enters. If I may remind you of that, if you have the Decision -- I have referred to paras. 4.65 and 4.67 before in opening. If you just go to paras. 4.79 to 4.80. This is the part of the Decision where Ofgem has already carried out in the previous pages its analysis of what it regards as the high costs of replacement under the Legacy MSA for DCMs if two particular replacement paths are followed which it contends should be treated as realistic. Those are the 50 and 65 percent scenarios you see reflected in Figure 7 on p.83. When you come to prepayment meters you only have those two paragraphs - 4.79 and 4.80 - and a reference forward to Annexe 4, which we looked at in opening. You see in para. 4.80 the way it is expressed - that,

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

Then there is the 'however' about what would happen. I saw it was said in the written closings of my learned friends, and it is their case, that that amounts to a positive finding in the case of PPMs. It does not. This is not an exercise in close textual analysis of the kind that Michelle Foucault might engage in One takes the language at face value, and it is not a finding of foreclosure in relation to prepayment meters.

So, we have a puzzlement - that Ofgem does not find the charges to have restrictive effects as regards the PPMs, but it does do so in an extended analysis as regards the Legacy DCMs. That, in our submission, immediately spotlights a lack of internal coherence in Ofgem's approach.

I see that the written closing submissions are here. If they can be handed up while I am speaking. None of what I am saying at the moment is reflected yet in that document.

I would like to pursue that thread about the essential lack of coherence in, as it were, the prosecution's case. To do that I would ask you please to turn up Ofgem's skeleton at CB2, Tab 15. I am going to take you to two references in this and then go back to the Decision, and then have a look at the defence. The first is a paragraph we did look at briefly before - para. 118 on p.41 of the internal numbering of the skeleton argument document. If you have para. 118 you will see that the way Ofgem approaches the question of restrictiveness there is in this way:

> "As for the point that National Grid could have constructed a Legacy MSA type contract with a shortened glidepath to make meter replacement much cheaper for gas suppliers (National Grid skeleton): this was in fact suggested by Ofgem during discussions with National Grid. However, the reason that the Authority has not put it forward as a counterfactual [it might have been] is that the Authority has grounded its counterfactuals in what is seen in the real world. But, it is clearly correct in theory that a dominant undertaking could adopt measures which, although they may not be reflective of 'normal' competition, are also not restrictive and therefore not abusive".

Pausing for a moment, it says to itself, "We don't say that this is normal competition because it's not akin to these other sorts of contracts which we take for our counterfactual, which are seen in the real world, but with a shortened glidepath you wouldn't have restrictive effects". This suggests that the restriction is the failure to make available more, or enough, free meters for competitors, for gas suppliers. But, how many before the line is crossed? It suggests that the form of the conduct is not the touchstone for finding foreclosure. It is the outcome, the exclusion of competitors from the market because there were not sufficient numbers of free meters.

So, that is one position.

Then if you turn back to para. 99 you have what Ofgem says about what it calls its 'no PRC counterfactual'. Here, by the no-PRC counterfactual what they refer to is what is in para. 98, the previous paragraph. They say there, it assumes that National Grid would have

charged competitive rentals. If I may pick up on a reference that you heard yesterday, when I said that Ofgem's defence regarded the charging at the price cap levels as hardly credible, that was because it appears in a different paragraph in Ofgem's defence. They say that at para. 3.17. I will not go there for the moment. But, no-PRC counterfactual therefore does focus for these purposes on the idea that under the P&M contract structure, if that had continued, what would have happened would have been that National Grid would have charged much lower rentals.

Now, on that basis, and saying that that is what would have happened, they say,

> "It is not a flaw of the no-PRC counterfactual that it may have led to lower rentals and, therefore, potentially fewer replacements. The lower rentals would have been a welcome consequence of competition. It would not have been abusive because it would reflect 'normal' competition.

So, if one pauses to digest where we are now, low pricing by National Grid, which excludes competitors to a much greater extent than the MSAs - because the price has been dropped right down - would not have been abusive. Why? Because in this case it is the lower prices which gas suppliers and consumers get which would have been the welcome consequence. So, it is not the exclusion of competition which is now the issue - it is the means by which it is brought about.

Just keeping that in mind, if you go forward to para. 113 and remind yourselves in the first sentence that although they therefore refer in para. 99 to the problem really relating to the level of the customer benefits which result, in the first sentence they also say that the Authority is not objecting to the level of rental payments provided for under the Legacy MSAs. "This is not an excessive pricing case."

So, on the note that it is the means by which exclusion of competitors is brought about that may be the problem, we go then to the Decision and what it says at para. 4.93. Ofgem is responding implicitly to the point that under the Legacy MSAs there are certain benefits. Here we are talking about the ability to exchange CREs without a charge which would arise under the age-related counterfactual. But, they say half-way down para. 4.93, "The Authority also does not consider that these arrangements mitigate in any material way for the significant foreclosing effects which the MSAs have for CMOs. In assessing the effects of the MSAs it is insufficient to look to the suppliers only and the potential short-term financial gain which the MSAs may provide for them".

There I interpolate 'short-term financial gain' would presumably be an expression sufficient to cover the reduction in rentals which accrue over the period. They go on:

"By binding the suppliers to take a significant proportion of their domestic gas meters from NG for a number of years, NG has substantially foreclosed the relevant market and restricted the ability of CMOs to enter and/or expand in the market."

Then the final sentence:

"Ultimately, suppliers and consumers will suffer as a result of the lack of competition in the relevant market."

So here the focus then swings back to the problem that what is happening is that there are fewer replacement opportunities again as being the key. Again, how and why and what is the touchstone?

The final document that I will take you to is the defence and a paragraph which you have seen before in CB1, tab 3, para.212, p.569 of the external numbering. If you pick it up from the second sentence, you will remember that they say there that what National Grid could have done, which would not have been abusive, would have calculating:

"… a reasonable estimate for the Legacy Meter population as a whole …"

That is of the unrecovered customer specific sunk costs –

"… for example, by subtracting from the historic asset value the reuse value of any Meters it removed at the date of the calculation."

Then using that figure, that lump, to generate age-related PRCs, and then test those in the market.

So even though that may well have resulted in a system of charges which have a deterrent effect on gas suppliers from deciding to replace the meters, very different now from what they have called the "no PRC counterfactual", that would have been non-abusive.

So if you try to put all of that together it is our submission that the question of Ofgem's position on the key point in the case remains ambivalent and shrouded in fog, but it is a question that you will need to decide. In deciding that, of course, it is a case of National Grid needing to show that the Decision is not soundly based rather than itself needing to establish some entirely new case and thereby developing something that hares off in a completely different direction. The question for the Tribunal is whether the Decision is coherent and whether it has proved its case.

THE CHAIRMAN: Is it? This is a merits appeal, is it not? It is not a judicial review of Ofgem's Decision. Is our task not to decide whether these contracts were abusive on the grounds that they are alleged to be abusive by Ofgem?

MR. TURNER: On the grounds that they are alleged to be abusive by Ofgem. That is absolutely right, madam. It is an appeal on the merits, it is an appeal on the merits against the Decision, and that takes us back to the task that we are not, therefore, beginning a new enquiry, we are assessing the Decision on its merits.

So what are the essential issues for you then which do decide, which should decide, whether Ofgem's Decision on the merits is soundly based or not? We say that there are a small number of points which have come into very sharp focus in these proceedings, which, in our submission, should be determinative, and I will mention three. The first point: it appears now to be common ground with Ofgem, its live factual witness and co-author of the Decision, and both its experts, that the use of a system of cancellation charges by National Grid as a way of underpinning the rental commitment in its contracts was both legitimate and normal and was not abusive. The second point is that it is also common ground that the amount of the rental commitment underpinned by these charges was not excessive in any way. The third point is that any system of cancellation charges, including one where these charges are set up so that they vary according to the ages of individual meters in the population, will involve making gas suppliers to some degree less eager to carry out meter replacements than they would be in a situation where they are subject to no payment completion arrangements at all – the P&M no notice sort of arrangements.

If you put those three points together, Ofgem's infringement Decision boils down to this alone: to a complicated and, in our submission, mystifying exercise carried out by the officials and Mr. Keyworth which purports to show that the form of the cancellation charges which was used in the Legacy Agreements in some way inherently results in higher costs for gas suppliers of replacing large numbers of installed meters in the years 2004 to 2006, which is its focus, as compared with a different form of cancellation charges, which is adapted from the CMO contracts for new and replacements, more than that would have done.

The Keyworth exercise is, in our submission, an enormously complicated side-show because it does not show anything revealing about the harmful effects of the contract structure. What determined his results, as the cross-examination sought to bring out, were other factors, including the numbers of free or cheap meters which he has put into his counterfactual comparison, and various other assumptions that he chose to make, such as the use of the 20 year cut off period for the PRCs when they become free to replace, as opposed to, say, 25 years.

You can set this sort of thing up so that it does assume what it seeks to prove. The Decision itself at para.4.161, which I took the Tribunal to in opening, explicitly claimed that the comparison was, to use its words, " revenue neutral construction". That basis of support for what was done by Ofgem was wrong and Ofgem withdrew it correctly as a claim in its defence, para.364, very shortly before this hearing. If you clear away all else, all of the many issues that you have been confronted with over ten days, those are reasons why this Decision falls to be set aside.

We go further than that in this appeal of course. This is a case where National Grid says that the contracts under attack were deals which did bring real concrete benefits to consumers and customers. You have heard evidence from a former senior representative of the major gas supplier in the negotiations, Mr. Neil Avery, who gave evidence, although he had nothing to gain by it, and set out his perspective honestly and truthfully for the Tribunal.

The features in these agreements which are objected to are flat rate charges which decline over time, a steady glide path and a tolerance band. They were there in large part, as you have seen from the evidence and heard from Mr. Avery, because that is what the customers thought would best suit them in the new competitive gas metering market. These same customers, the gas suppliers, are placed by Ofgem at the hub of decision making in the competitive environment. The features under attack are benign. There is no reason for Ofgem to have launched a retrospective attack upon them.

Madam, with that, I hope that the closing submissions document should have made its way to the Tribunal, and I shall now largely be speaking to this and I hope most of the references are there.

I will deal first, as quickly as I may, with the factual context which, you have heard now in oral closing submissions from everybody, is crucial. The oral evidence we say has confirmed the correctness of our original presentation of the factual case in the appeal. You heard from Mrs. Frerk, as I say, a co-author of the Decision, about the circumstances of this transition, this strange period when we moved from regulated monopoly to competitive metering.

First, she confirmed Ofgem's perspective from May 2002 forwards, that there was a problem which arose in relation to the transition, because in normal conditions, as Ofgem's document made clear, you do expect meter providers in this sort of industry to contract in advance to protect themselves against the risk of their installed assets being removed before the investment has been recouped. I would ask you to read this part of the transcript, if you

would pick up the transcript bundle and go to p.20 in day 6, which is Mrs. Frerk's evidence, and pick it up at line 9 where, after being referred to the point in the 2002 document about how stranded meter assets is only likely to be relevant during the transition she was asked:

> " So actually in the normal competitive market you would not expect this problem to exist? A. You would expect the CMOs to do something before they made that investment to ensure that it was secured in some way.
>
> Q So we are really concerned here with some transitional, some strange problem resulting from the transition to competition, when you are talking about the problem of stranded assets? A. Well in part 4.13 was intended to send a signal to the rest of the world that we actually believed it should not be a problem going forward because there were those in the industry who were saying that nobody will come in and invest as a competitive meter operator, because they will be worried about stranding, in particular if customers switched between suppliers for example. So what we were trying to do there was, first, signal that we did not think that should be an issue going forwards, but to focus that the real debate and the issues that we were discussing and on which we were interested in views which was around the transition with National Grid.
>
> Q How do you see people contracting as meter providers in the normal competitive environment? What sort of contracts do you see them as competing for? A. What sort of contracts?
>
> Q How do you see them contracting for the provision of their meters in a competitive environment? A. Well the contracts that we have seen have termination clauses, or premature replacement charges built in in most cases.
>
> Q What do they do? What do they achieve? A. They ensure that the competitive meter operators, as far as possible, recover their investments that they have made in those meters"

And the problem, if you keep it open for a moment, that she explained arose from the fact that, as matters stood, the P&M no notice terms created an issue, essentially of perverse incentives because National Grid's interests lay, as she correctly saw, in keeping their prices high at the tariff cap levels to minimise its loss, and that would encourage in turn the gas suppliers, prompt them, to carry out more accelerated meter replacement and that would lead to premature meter replacement and adverse effects and if you have open still the

transcript, and look at p.24, you see how Miss Frerk dealt with it at line 16 where she was asked:

> "Q So, in the language of the 2002 strategy document from May, National Grid would seek to reflect the risk of losing a customer in its prices by pricing as high as it can do compatibly with the regulated price caps. It cannot go above them – It cannot raise them above that regulated level, but that is its strategy. A. Yes.
>
> Q Inevitably, that will trigger the premature replacement of meters from National Grid's Legacy meter stock. A. Yes.
>
> Q Your note then identifies premature replacement arising from this dynamic as a problem. A. Yes.
>
> Q The problem is framed in terms of a few meters being ripped out - not the large scale and rapid undue premature replacement that you refer to in your statement. A. (After a pause): I mean, this is my doodling in personal brainstorm mode in my notebook. I suppose, looking back, trying to read back into how I was thinking at the time, that is how Grid would've seen it.
>
> Q So, let us look at the options that you thought would address the problem? It is immediately underneath. Do you see the bottom option - 'Cancellation Charges'? A. yes.
>
> Q So, you are identifying cancellation charges as an option for addressing this problem of National Grid's Legacy meters being prematurely replaced. A. Yes …"

So she has confirmed that Ofgem was concerned about premature replacement and the consequences for the public, for consumers, in particular, and we have given the references, I will not read them all, she confirmed that Ofgem was concerned about replacement by gas suppliers which would be economically inefficient, wastage which raises industry costs and would run counter to customers' interests. By "customers' interests" that means the disruption, the customer disruption which occurs. Customer disruption I will return to in a moment, it is not something which, although from an outsider's point of view and in this hearing might seem to be a very minimal inconvenience, in fact, as you will see customer disruption, particularly when multiplied on a wide scale, many people having to remain at home for hours or half a day, to wait for a meter to be replaced is a very significant problem and Ofgem was absolutely right to be concerned about it.

The CMOs, whose ongoing costs might be no lower than National Grid's could still enter the market because National Grid's prices were set at this historic basis at above the prevailing market level, and that prompted the concern which you saw she voiced within the Ofgem tent as giving rise to artificial or uneconomic competition where she described – I hope this is in the note –

> " … competition where you have got players who are coming in and are only able to compete because there is some artifice of the regulatory environment that means it looks like there is an opportunity there when actually there is not." (day 6, p.42, lines 5-7)

What was Ofgem's vision for competitive gas metering as revealed by the 2002 document. It was not directed at encouraging large amounts of frenetic activity and premature replacement, as the document referred to it was designed to deliver competition that in some sense, and I quote: "would operate invisibly for end consumers." Why invisibly? Because the expectation is for the incumbent the prices are lower and that meters are replaced with other meters competitively at the end of their natural life. So although this does not by any means rule out some premature replacement, if gas suppliers seek benefits from upgrading which justify the costs, competition normally would involve alternative meter providers having the opportunity to put in new meters when the old ones need replacement, and there are various sources for that. You see that in the 2002 paper, and I took Mrs. Frerk to the references at the end of chapter 4 as well, where there was the concern expressed: "How do we deal with premature replacement for the consultation?" and there were also the communications within Ofgem, to which I referred as well. I do not know if you have the Frerk cross-examination bundle to hand? (After a pause): If you turn to Tab 5, when you have that bundle, and turn to p.779, this was an e-mail from Mrs. Frerk to members of her team - Mr. Baldock and Mr. Osborne. In it she is discussing the proposed tendering by British Gas for competitive metering. This is dated 7th November, 2002. The reference is the position of UU (United Utilities). In the second sentence, third line down in the first paragraph she said,

> "BGT have said clearly to us that initially they will only be changing out meters when they come to the end of their lives or other meter work is required - which all seems sensible".

The other parts of that e-mail are to do with the question whether British Gas are, in fact, going to engage in a more aggressive programme of changing out meters. If you have that bundle and turn forward in it to Tab 6, the next tab, at pp.882 and 883 you have this e-mail

from the former member of Ofgem's team, Mr. Baldock (who left in 2007). On p.883, in the second bullet and in the remainder of it ----

THE CHAIRMAN: Those are in yellow in my copy.

MR. TURNER: Are they? I am sorry. They are not in mine. If you would read to yourselves then the last few lines of the second bullet beginning, "BGT were keen to adopt this approach --" the features which Mr. Baldock, one of the architects of the new competitive metering market is referring to. There is reference to organic growth, and so on. That is the vision for what competition in this industry was thought to involve, at least for the early years. We see that. Those are the years, of course, with which Ofgem's Decision is concerned.

You then heard how National Grid approached Ofgem in view of all of this, requesting a regulatory solution at first to the problem, to cover this transitional issue. That was, "Please, can we re-open the price control? Can we deal with this in some other way through a multiplication?" You have heard that Ofgem's response was "Don't keep banging on about the price control. Go away. If you can come up with some other creative idea, then do so". That led ultimately to today.

Mrs. Frerk acknowledged that Ofgem specifically encouraged National Grid to identify a market solution to the problem. You saw, because we went through it step-by-step, how, in dialogue with National Grid, by meeting, by letter, by e-mail a proposal emerged under which the problem would be addressed by National Grid offering annual price reductions to gas suppliers in conjunction with premature replacement charges. From early September 2002 that was being discussed not as a change to the network code, but it began to be talked about as an alternative market solution which would be offered in the alternative to the regulated terms.

You then have the important management committee document in February 2003 in which Ofgem records that gas suppliers had welcomed the proposal - it has taken soundings - 'as bringing down prices whilst still allowing them to install meters at broadly the rates that they would have done anyway', and that allowing National Grid to sign commercial contracts "would seem to be the most effective means of ensuring an efficient industry outcome". The author of that - a senior economist at Ofgem - drew specific attention to the availability in the bargaining of these regulated terms as a factor which could "weaken the ability [I am using his words again] of National Grid to abuse market power in setting the terms of the contracts". The idea was, at para. 16 of that note, which I will not open up, to allow National Grid to find a market solution to the problems which Ofgem had identified.

So, after that I say only that you saw how, based on the discussions with gas suppliers about what they wanted, how they would like these arrangements to be structured, you came to the idea of these PRCs, the concept of the linear glidepath -- that that was developed, it was shared with Ofgem as Mrs. Frerk correctly appreciated, and how Ofgem then pushed National Grid to consider not only offering significant price reductions to the gas suppliers, but also what she referred to as flexibility. Build in the ability to carry out free replacements, some headroom above the historic pattern of removing meters. As Mrs. Frerk acknowledged, National Grid then pursued these contracts, it found the market solution, and those were the contracts which you are confronted with today.

There was an issue about whether pursuing this route at all was, in some sense, illegitimate. Counsel for Ofgem said in opening, "We were surprised at the development because we thought that it had all been wrapped up in the price control in some way". Well, Mrs. Frerk has confirmed that the May 2002 document had highlighted that the issue of stranding through competition existed in relation to the installation costs of National Grid's domestic gas meters. Now, whether she was concerned about looking after National Grid's commercial interests, or, as she says, more interested in the way in which this imperfection affected the public and consumers is not to the point. She recognises the issue of stranding, and she explicitly envisaged that that problem could be partly addressed by the introduction of these premature replacement charges. It is against that, and inconsistently with it, that she seemed to suggest that the regulator's decision to continue valuing the assets - that is, all of the assets (the transportation and the metering assets) - on an unfocused basis in the price control review in 2002 in some sense made it illegitimate for National Grid to take any steps to protect itself from stranded costs -

> "that, notwithstanding the acknowledgement" that the way we had set value to the metering assets, i.e. the price control, we knew left Grid with a very significant stranding risk (Transcript, Day 6, p.7, lines 11 to 13).

You were taken to a National Grid document by counsel for Ofgem (I believe one of these public documents to investors) to try to suggest that National Grid from that had in some sense benefitted to the tune of £2 billion from some kind of windfall as a result of that decision, and that you should offset that. Against what? Against the ability to impose any form of premature replacement charges at all, perhaps.

There is no evidence of any *quid pro quo*, to coin the phrase that was used in oral argument. Ofgem was specifically asked by National Grid to produce some documentary evidence to support this suggestion which is in the Decision (para. 2.59) that both sides were aware that

the stranding risk was a part of the price control discussions and somehow factored it in. No such evidence was produced. Because this is something that on our side is felt quite strongly about because of this suggestion, relevant or not to the issues, I would spend two minutes just showing you this. If you go in the Decision to para. 2.59 (CB1, Tab 1, p.24), at the foot of the page,

"As explained in the final proposals [which is Ofgem's document for the price control review], Ofgem concluded, for all of these reasons, that any stranding costs arising from the introduction of domestic gas metering competition were a matter for National Grid's shareholders. National Grid could have rejected the overall price control proposals. If National Grid had rejected the proposals, Ofgem would have referred the matter to the Competition Commission. NG accepted the price control."

There appears to be a suggestion, therefore, that "you essentially benefited in that way, you have had any compensation for stranding that you deserve". That was repeated in Mrs. Frerk's witness statement as well.

So after that arrived National Grid wrote to Ofgem asking it what on earth this paragraph was based on. If you pick up bundle CR2 and go to tab 126, p.630, you see that a little while after the Decision has arrived, which we were still involved in preparing the notice of appeal, there is a letter to Mr. Sinclair of Ofgem, and at para.1 it says:

"Please would you direct us to the passage of Ofgem's final proposals which are relied on in support of Ofgem's conclusions in the first sentence of paragraph 2.59?"

Where has this come from? The answer is at tab 130. I am not going to read this all out aloud, but essentially after referring to the relevant sentence you will see at the end of the second paragraph:

"Whilst not explicitly stated in the Final Proposals, it is the only reasonable inference that, unlike an RPI-X revenue allowance, a tariff cap in general (and this tariff cap) would not provide a guaranteed revenue and therefore exposed NG's shareholders to both volume and price risk."

We then write back at tab 142. That is a letter of 9th May. Under the heading, "Paragraph 2.59 of the Decision", if we skip over the sentence from the Decision which is repeated:

"From your response, we now understand the position to be:

1. The Final Proposals did not in fact state anywhere that any meter asset stranding costs arising from the introduction of domestic gas metering competition were a matter for National Grid's shareholders.

2. The phrase '*a matter for National Grid's shareholders'* does not mean (as the uninformed reader might suppose) that it was expected that National Grid's shareholders would have to bear the meter asset stranding costs arising from the introduction of competition.

3 Ofgem's point is that the tariff cap put in place by Ofgem in 2002 did not provide a guaranteed revenue and therefore National Grid's shareholders were exposed to both volume and price risk. National Grid was not, therefore, precluded from seeking to mitigate this risk, as far as it was practicable to do so, and so long as it did not resort to methods that were not consistent with normal competition."

Over the page, that we did seek to mitigate the meter asset stranding risk through the commercial contracts.

What is Ofgem's answer to this? It is at tab 147. It does not take things any further:

"To the extent that these areas remain matters of contention, we are of the view that they should be addressed as part of the formal appeal process …"

So I am doing it now.

What you draw from that is that the part of the Decision which was the basis for the suggestion that was made about this is not accurate in so far as it suggests that there was some *quid pro quo* arrangement or understanding that the price control review gave a benefit which should not be addressed, for example, through mitigating measures such as the Legacy MSA agreements.

THE CHAIRMAN: You are saying that, in fact, this paragraph could be read as saying the contrary, that the stranding costs were considered a matter for National Grid's shareholders, which is a rather ambiguous phrase, but it seems in the correspondence to be saying it is a matter for them and because nothing has been done about it, therefore they are exposed to the risk, which would be the opposite of what is now being said, which is that this was all taken care of in the price control.

MR. TURNER: That is right. In so far as it is ambiguous because it is capable of both of those interpretations, we were concerned that the harder interpretation, the *quid pro quo*, was being voiced and was produced against us in this appeal process. We have shown you the

documents now. It does not have the basis and of course it was inconsistent with what actually happened in the dialogue with Ofgem and in its public statements.

All that the point amounts to, if it amounts to anything, is this: Ofgem decided not to deprive National Grid of £2 billion as a result of the way it chose to value these assets in the price control. National Grid was not better off as a result of that decision, simply to follow the previous practice for valuing assets as the appropriate way to do it. They chose what they thought was the appropriate way to value all these assets. Mr. Smith's evidence, which has been constantly referred to, merely confirms that Ofgem chose to continue using the approach which had first been chosen by the MMC in 1997. Could you just have a look at his witness statement in WS3, tab 7, the first document behind that tab at paras.45 to 46. If you read that you will see in 45, if you look at 45 at the bottom of that page, he describes that an element of the price control review was whether a focused or unfocused approach should be taken to the valuation of these different assets, and that the Authority took the unfocused approach to considering everything. Then you get 46, which is the effect of applying the unfocused approach was to:

> "… significantly increase the overall regulatory value of Transco's assets, and consequently to increase the allowed revenue of the monopoly transportation business. Ofgem estimated at that time that that this decision provided a substantial benefit to Transco's shareholders."

Then there is the reference to the £2 billion.

> "In looking at the potential stranding costs that Transco's shareholders might face with the decision to introduce metering competition …"

that is what we are concerned with now –

> "… this is an important consideration, The price control settlement which was offered to NG was offered as one settlement covering both the main transportation control including the decision to use an unfocused approach and the metering control. When the NG Board …"

and now he is thinking into the position of the National Grid board –

> "… was considering whether to accept or reject Ofgem's proposal, it would have considered the matter in the round."

That is what it would have done.

> "It therefore cannot be said that NG would not have approved the proposal unless it had been sure of recovering its historic metering investments."

So that is his evidence, and in a sense it is of course true that they chose to value the assets on this unfocused basis. When he says it provided a substantial benefit, however, you have to understand what that means. It does not mean "as compared with the previous situation, for example, at all. It means compared with something Ofgem decided was not the appropriate way to value the assets. The rest of it is some inference about how the National Grid Board would have thought.

THE CHAIRMAN: Well this is very carefully worded, because in the middle sentence where it says; "This is an important consideration", if it had said: "This was an important consideration" that might be read as indicating that this was something that people were thinking about as your sort of *quid pro quo* point.

MR. TURNER: That is it. The reference to " This is an important consideration" is essentially argument. I am just reminded by Mr. Pickford that Mr. Shuttleworth deals with this at paras. 82 and 83 on focused and unfocused.

Essentially, and I will summarise it, it is a prejudice point. There is an implication that we had no legitimate interest in using these contracts to protect ourselves against the stranding risk, is inconsistent with the position that this represents normal competition in the market and is inconsistent with the encouragement that was given and what was said. That is it, that is the essential backdrop against which this case needs to be considered by the Tribunal. National Grid is penalised over £41 million for having adopted the market based solution, which the gas suppliers at the 'hub', considered beneficial for them and for their customers, and which Ofgem says addresses the transitional problem they had identified and had not remedied with a regulatory solution. That is the factual context.

Let us go to the analysis and start with market definition and dominance. The first point is that, although faintly – increasingly faintly – Ofgem advanced the pleading point against National Grid by saying that National Grid has not challenged our case on dominance if you, the Tribunal find that there is one overall market for meters which includes the Legacy and the new and replacement meters. That is not right. It cannot be tortured out of the notice of appeal that we make such an implicit acknowledgement. The notice of appeal makes a substantive challenge to each aspect of the reasoning throughout that dominance section – market shares, the barriers to entry, the buyer power – perhaps at excessive length, it leaves no stone unturned. Our arguments apply independently of the precise definition of the relevant market, and you cannot reasonably say you can be taken to have accepted that you are dominant in a single overall market, and nor – as a point of accuracy – is it correct to have said that we did not allege otherwise until this very hearing. For specific

confirmation, and I will only give you the reference – our skeleton argument, para. 3) National Grid is not dominant in any relevant market.

On the substance, I begin with market shares and market definition. This is an area which, in our submission, has attracted more heat than light perhaps because it is somewhat abstruse, but our essential point is that it is wrong to focus on this as being some meaningful battlefield. Market definition is principally relevant insofar as Ofgem seeks to rely in the decision, in its analysis of market power, on the 97 per cent share of the total number of installed meters as at January 2004. Why? To raise a strong presumption that National Grid must be classified as dominant, and you heard Mr. Vajda referring to the need to show exceptional or extraordinary circumstances to push the other way.

This then takes us to the first of three legs of reasoning as to why National Grid is said to have market power, the market shares. Our point about market definition and the meaningfulness of these market share presentations was summarised in the note we handed up, another snowball in the avalanche on day 2 with the attractive title: "Up against the wall: a note on bargaining and market definition." I do not know if you recall that, or if you have a copy, I will not ask you to turn that up necessarily now if it is going to take time, but I will explain the essential points which are in it and ask you to look at it again after the hearing.

The first point: everyone agrees market definition is a tool for assessing market power. Why? Because you are trying to assess a group of products over which the conditions affecting competition are sufficiently homogenous to make sense in order to treat them as being in the same market for competitive analysis. What you are interested in, when you are looking at market power, and trying to draw conclusions, is the ability of an undertaking to behave independently of other forces, of customers and other people in the market, and that is where the reference in the Commission's most recent document to "being largely insensitive" comes in.

In the present context, the focus for the Tribunal is on the bargaining strength of National Grid, vis-à-vis the gas suppliers in the Legacy MSA negotiations. Our point on market definition can be simply stated as being that the competitive conditions which affect you when you are bargaining as a supplier of a gas meter with a gas supplier for the rentals, your competitive constraints are going to differ, depending on whether you negotiate before or after you sink your cost.

THE CHAIRMAN: So this is the countervailing buyer power argument effectively, but is that an argument that is relevant to market definition or do you do what Dr. Williams did, which is

say: "What we are concerned about is what the relative bargaining strength of the parties in negotiating this contract were", and so we can jump over market definition and go straight to dominance effectively?

MR. TURNER: We do take that view. What we were trying to do with market definition is say to the Tribunal, they present a table where you see these 97 per cent market share figures going down to 89 per cent over the course of a few years. You have heard the conclusion being drawn, as in any normal case when one observes these sorts of figures one can draw a very strong presumption that needs to be rebutted. What we seek to do is to say that those market share figures, if you want to classify it in that way, need to be interpreted with great caution because within that overall market you have assets which are subject to very different forms of competitive conditions in bargaining, and that in strict terms Dr. Williams' opinion is for that reason you should not be presenting them as part of the same market for the purpose of analysis, so it may boil down – and in our submission it does boil down – to a purely technical issue of classification.

THE CHAIRMAN: Well, yes, but in your notice of appeal you put your case on the basis that there were two relevant product markets, the product market for Legacy meters and the market for new and replacement meters, and you set out that table to which we have been taken a number of time, which purports to give the market share in the market for new and replacement meters.

MR. TURNER: Yes.

THE CHAIRMAN: Now is that still your case, or have you moved away from that?

MR. TURNER: No, I have not moved away from it so, yes, you will need to make a decision on it, but let me explain precisely what we refer to that table in the notice of appeal for, because that was not correctly interpreted on the other side, and what we say in relation to market definition for the purpose of the 97 percent presentation in Ofgem's Decision - the reason why we say Legacy meters should be treated as falling into a different market from the new and replacement meters does relate to the conditions of competition. It is because when you are bargaining over Legacy meters you have the position that the costs are sunk and you face the threat that the customer can say to you, "Well, I can take this out. You won't get your investment back. You're in a weaker position".

When you are negotiating with the customer for the new and replacement meters you are not in that situation. You have not sunk any costs. That problem does not arise. Our case on market definition is that the issue of there being conditions of competition which are homogeneous is an important indispensable, and crucial part of the test on market

definition, and because you have different bargaining dynamics here affecting these two different things, it is wrong to present a single market. That is what the case is.

THE CHAIRMAN: But, if that is right, and if the Legacy meter market is a separate market, in which market is this alleged conduct taking place?

MR. TURNER: The alleged conduct is taking place in relation to the Legacy market - because there is bargaining over the continued provision of Legacy meters.

THE CHAIRMAN: So, how does it help you to have defined a new and replacement market with smaller market shares if you are still left with a Legacy meter market in which you have a huge share? I perfectly see the point that may, or may not, mean that you have any market power in these particular instances. That is a separate point. But, how does it help you if the conduct which we are considering is conduct either in that Legacy meter market or at least conduct which is using, or is alleged to use, the power in that Legacy meter market to affect competition in the different, but neighbouring new and replacement market in a *Tetra Pak* sort of way.

MR. TURNER: Yes. It is for clarity of exposition. Whether it is 97 percent or 100 percent is not going to make a difference to the way that you examine the essential question at the end of the day of the dominance. What does matter though is that once you appreciate the special features of the Legacy meter base you appreciate at least two things: first, because of this sunkness aspect, that these assets, which you do not have when you are bargaining before you have sunk the costs -- You need to look at those figures with that in mind. Secondly - a point which Dr. Williams I think also made in the course of his oral testimony, and which interestingly enough was picked up by Mr. Keyworth in the course of his cross-examination - with the Legacy assets you are dealing with things that cannot be re-deployed. They sit there on the wall and, as Dr. Williams said, in one sense they are in a world of their own. You have, if you like, lots and lots of little markets which can all be aggregated together.

THE CHAIRMAN: That is not how you put it in your Notice of Appeal though. In the Notice of Appeal you did not put forward a case that there are 22 million markets.

MR. TURNER: That is quite right.

THE CHAIRMAN: The purpose of the Tribunal in having to identify what it is we have to decide on market definition -- Is it your case then that this ‘world of their own’ point is actually the correct way to define these markets - because that seems to me different from what you said in the Notice of Appeal about there being one market for Legacy meters and one market for new and replacement meters?

MR. TURNER: It is an additional point. You are absolutely right to point that out. It was, of course, in Dr. Williams' report, and he spoke to it. It is a matter for you whether you take that up or not. I am content to say that we rest with the way we have put it in the Notice of Appeal, which spotlit the point of the sunkness and the implications of that for the bargaining as being the key distinction.

So far as the paradox that was referred to by counsel for Ofgem is concerned - that on the one hand you say that there is this large competitive constraint from the threat of replacement, but on the other hand you will not accept that these are in the same market - we do rely on the way that Dr. Williams put it in his testimony. I hope that the extract is set out in the note at p.7. If you read to yourselves the extract from Dr. Williams' testimony at the bottom of p.7 -- (Pause whilst read): He makes the point that it is not as though there are specific products out there which are exerting a constraint, or anything like that. It is the threat of replacement. That is what he described as having no mass. That is why, in a sense, it make sense to treat that threat as something from outside the market exerting a pressure on the bargaining that takes place over the continued provision of the Legacy meter stock. He refers to the huge competitive impact. But, where it was coming from -- Of course, the new and replacement meters may not have even been produced. Indeed, contracts may not even have been struck yet between gas suppliers and CMOs. Npower, for example -- SSE -- They threaten accelerated replacement. They threaten it although they have not engaged any CMOs. We have seen the direct evidence that that exerts a competitive constraint causing National Grid to say, "Well, we will have to offer you a better deal resulting in the Legacy MSA terms". That is how it is put.

What follows from that -- Well, the criticism that was made by counsel for Ofgem and the interveners about Dr. Williams is that he failed to grapple with what they called 'the real world' because he failed to acknowledge the demand side substitutability of replacement meters for the purpose of market definition. They say, "It's blindingly obvious".

The response to that is that he does not fail to grapple with the real world. He acknowledges - and we rely on this competitive threat -- It is only that we say it is a question of classification and that technically you classify that as coming outside this market definition.

THE CHAIRMAN: There is still this issue about, "What is the product? It is not the gas meter. It is the metering service". There does seem to be evidence - and we have seen graphs with all different lines on them - where gas suppliers say, "Okay. Next year we have to have our gas measured in X million households. What would it cost us to do that if we kept the

Legacy meters? What would it cost us to do that if we had new people's meters?" It is an ongoing expense that they are weighing up the alternatives in relation to.

MR. TURNER: Yes.

THE CHAIRMAN: But, you still say that that does not mean that those products are competing with each other?

MR. TURNER: It is, as it were, dynamic there. The gas suppliers are looking forward over quite a long period of time and working out for themselves, "How much better off are we if we stay on the P&M terms and switch out the Grid-installed meters as quickly as we possibly can?" There, it is the threat of replacement by those as yet unborn products or those future services which exert the constraint. But, as in the same way that issues of potential competition can constrain behaviour in a market analysis, that threat, which as yet has no "measurable mass", to quote Dr. Williams, is very real but cannot meaningfully be thought of as part of the same product market at the first step in the analysis.

THE CHAIRMAN: With this "measurable mass" idea, when you are looking at supply substitutability in *Continental Can,* for example, there you are including in the relevant product market the potential production by a manufacturer who is not currently manufacturing the product that could rapidly switch its production to that product. So those are also non-existent products, although I suppose then what you are including in the relevant product market is the products that they are in fact producing, whether they are metal containers or glass containers, or whichever way round it was.

MR. TURNER: First, you are right, that that is exactly how it works, and secondly, if you go back to – I see Mr. Pickford is on to it already – the EC Commission's Notice on Market Definition, that very point is made at para.23, just above "Potential Competition", in relation to supply side substitutability the Commission says that in some cases you can treat products from a supply side as within the same market, but in a number of cases, and this would be a pretty good example of that sort of situation, you examine issues of supply side substitutability outside the market definition. That is paras.14 and 23, when you come to look at it, as well as para.24 of the Commission's Notice on Market Definition.

THE CHAIRMAN: Yes, whether you regard them as constraining because they are in the same product market or because they are potential entrants into the product market perhaps you would say does not matter.

MR. TURNER: Yes, but you will see anyway that for that sort of supply side substitutability, interestingly the Commission Notice says in that sort of case do not include it in the market.

That takes us to our market share table, the one that has been referred to constantly. I need to clarify what it is there for, what it is meant by us to show. We are not using that, and it follows, madam, from your question, to try to show that the strength of the competitive threat which National Grid faced at the time it negotiated the Legacy MSAs was X. What we rely on that to do is a different thing, which is to give you, the Tribunal, a good indication of the progress in competition in the gas metering market since the conclusion of the Legacy MSAs. It relates to this issue of foreclosure. When you read the Decision you do get this feeling, it is said at some stage, "stifling" of competition in the early years. The point of that table is to set the developments against the allegation. That is how we rely on that, and only that way.

With that, if I pass to the second leg and I am going to pick up pace, if I may, but if it is convenient for the Tribunal to take a break at this stage I am happy to do so.

THE CHAIRMAN: Yes, I think we will resume at noon.

(Short break)

MR. TURNER: Madam, I am not going to say anything more about market shares. So that takes us to the second leg of the three legged stool, which is barriers to entry, and if the Tribunal will open the Decision at tab 1, p.56, paras.3.66 to 3.74, which contains the section. You will recall the essential point here that in 3.66, barriers to entry, it is correctly defined as this situation where the incumbent undertaking has, by virtue of incumbency, a competitive advantage over potential or new entrants. Then 3.74, the end of that section:

> "NG has itself recognised that it had … significant economies of scale and density resulting from its installed base of meters."

That was the case then. This new point about the ability to reduce its prices broadly was not part of the Decision.

> "This gives NG a significant advantage in carrying out new and replacement work."

This is as against the competitors. The reasoning in support of all of that is contained in the intervening paragraphs.

You will recall that in opening our submission was that they failed in those intervening paragraphs to identify any specific advantages which National Grid enjoyed by virtue of the Legacy meter stock when competing for the new and replacement work. This is not a case where it is alleged that we should have had an obligation to sell the installed assets.

Ofgem's counsel in response sought to address what I had said by supplementing the analysis in the Decision. If you look at the note which we have handed up, the written

closings, at para.15 and refer to those points there, and taking them briskly, she refers first to the practical logistics of buying and installing a large number of meters, which logistical challenges apply equally to us.

She then referred to the need to have a competent workforce – again not stated in the Decision – said to give us a huge advantage. There is no analysis of that, and what evidence there is, which is unchallenged, is Mr. David James, who said that the CMOs did not face a significant barrier in obtaining the access to the labour.

She referred to the established network systems. There was no further reference to that.

Finally, she referred to advantages in density of operations through combining replacement with maintenance work. You will again not find that in the Decision. That is contradicted by the unchallenged evidence of one our witnesses, whose statement you have, Mr. Spence, who said that, in fact, maintenance work can get in the way of the efficient planning of the replacement work.

THE CHAIRMAN: Do you say there are no barriers to entry in this market?

MR. TURNER: Yes, we do say that. We certainly say this is an appeal against the Decision and its findings and the quality of the evidence. There is not anything there. Mr. Holmes reminds me, when I say "barriers to entry", what I am talking about of course is something, as Ofgem says, which gives the incumbent an advantage, something that we have in our pockets which the others cannot match.

THE CHAIRMAN: Does the barrier to entry have to be something that is created by the incumbent? Can it not just be existing?

MR. TURNER: Oh, yes, it might be something which is outside of our control. In this case it is not alleged to be that. It is said to be the installed base of assets. The essential idea is that we have a head-start or some advantage. What is the activity in relation to which we have that? It is competing with them in putting in new and replacement meters. Where does it come from? It comes from this feature and the installed base of assets, it is said. Our point is, where is the reasoning to support that? Why do we have advantages by comparison with the new entrants in relation to this activity? What it boils down is only one thing. Perhaps just before mentioning it I will refer to para.18 of the note, just to remind you that the way that my opening submissions were addressed, apart from referring to new factors, was by saying, well, look at these paragraphs, you have something which is a perfectly reasonable reference to what we are talking about, which is not a sufficient answer to the point that there is no cogent reasoning on this issue.

There is one point, and I take that up next in the note, which is at para.3.74, this reference to a recognition of economies of scale and density resulting from the installed base. Pausing there, they were wrong about density because we never said anything about density at all, so you can put that away. For economies of scale they are right in the sense that, as counsel for Ofgem correctly said, by referring to para. 288 of our notice of appeal, we did accept that we may have some economies of scale in operations in matters such as developed communications systems. That I accept. But, what you have to do in establishing whether there are barriers to entry in the exercise is weigh against that whether there are other factors which might point in the other direction so that on balance the incumbent does not enjoy significant advantages.

THE CHAIRMAN: In your para. 15(a) I am not sure I understand how the second sentence links in with the first. You say one of the alleged barriers is "the practical logistics of buying and installing a large number of meters. The logistical challenges apply equally to NG", but the logistics we are talking about there are they not the logistics from the point of view of the gas supplier in organising the much faster replacement of the legacy stock, so I am not sure why that applies to National Grid equally or at all, or are you talking about the logistics of the CMOs?

MR. TURNER: I think it does mean that because we are here concerned with advantages that National Grid as a meter provider in relation to the new and replacement work has got over alternative meter providers or CMOs. Although it is not written in the Decision, a reference was made to the practical logistics of buying and installing these meters. It is the meter operator which buys and installs the meters, and you see the point we make there which is, yes, you do have to buy and install these meters, but there is no reasoning, there is certainly no evidential support for the idea that National Grid enjoys some advantage in that direction.

PROFESSOR STONEMAN: Following up the same point, you may argue that it is not a point that is made but as the incumbent National Grid does have the advantage that as many meters are difficult to access the National Grid has accessed them at least once in order to put a meter in, the difficulty to access makes it very difficult for a CMO to change that meter, and to benefit from the existence of that meter. So the fact that you have the legacy meters, you have all the advantages that come from difficulty to access in terms of maintaining a future rental stream.

MR. TURNER: I see, sir, what you are saying, which is that there is an inertia issue, there is some difficulty in actually getting in and taking the National Grid meters out to put in your

own. But here we are concerned with, and Ofgem's decision is concerned with whether, in the business of replacing installed assets National Grid has some measurable advantage over new entrants. Yes, it can enjoy continued rental stream from these installed meters for so long as it is difficult to take them out. Here, however, the focus is on the competitive activity of trying to replace them and in that whether National Grid is somehow ahead of the competition.

PROFESSOR STONEMAN: I think that is what I was arguing, that it is very difficult for the CMOs to access them, and therefore you have an advantage in the sense that it is your meter, and you are getting the rental from it and the fact that it is difficult for the CMO to reach them means that you benefit for longer than if it had not been difficult to access – that, you would only get as the incumbent.

MR. TURNER: I understand that point. Whether it is a barrier to entry point in relation to fitting new and replacement work I would not accept. I do, of course, take the point, what I would say is in relation to the difficulty of access it is quite right that it is also something which National Grid, if it wanted to replace meters, faced; it is sometimes difficult to replace a meter no matter who you are.

THE CHAIRMAN: This point that has also arisen in a different context about whether or not Ofgem had expressed concern about the too rapid replacement of meters. If we accept that there is evidence that at least the gas suppliers thought that that was what Ofgem was telling them, is that a barrier to entry that is generated because it means that the gas suppliers who do not wish to cross Ofgem are going to be unwilling to carryout a much more rapid replacement programme?

MR. TURNER: I return again to how we see barriers to entry, which is accepting the way that it is presented in the Decision, which is focus on some competitive activity and ask yourself whether, because of some features – whether they are outside National Grid's control or in its control – National Grid has an advantage, so that it is more difficult for competitors than it is for National Grid.

In relation to possibility, we say there is sufficient evidence for you to conclude that the gas suppliers believe that the Regulator was saying do not switch these meters out faster than a certain rate, that is a constraint that was exercised upon them, which is an important market fact when you come to issues of competition and so on. In terms of the barriers to entry analysis we say it is not relevant to this.

THE CHAIRMAN: Thank you.

MR. TURNER: What we do have then is economies of scale. I have made the point that from National Grid's point of view we acknowledge that are and it is absolutely right we said that in the notice of appeal, but two points: we have never said that was significant, it has never been investigated, and importantly there is a whole area of the notice of appeal ----

MR. SUMMERS: I am sorry to interrupt you, I think I need to be clear in my mind whether, when we refer to National Grid in terms of barriers to entry, we are talking about National Grid the company, or National Grid the brand, because a brand can, of course, be a very significant barrier to entry to climb over for newcomers in terms of one which has a reputation, for instance, for reliability, it may make it very attractive for those who want training as meter fitters to go to obviously the established brand.

MR. TURNER: Yes, I understand that.

MR. SUMMERS: So what is the answer?

MR. TURNER: I cannot remember whether a note was handed up, or whether it was simply dealt with through Colin Shoesmith's testimony as to National Grid metering and UMS and the differences between them. Essentially, as I understand it, National Grid Metering is the entity which provides meters under the new and replacement contracts. UMS is the competitive, unregulated entity, which provides new and replacement meters in competition with the other CMOs. There was a suggestion made that UMS benefits from the association, which I recall in opening, with National Grid, and that overall National Grid's reputation – the brand – is an advantage. Now, as to that I am not in a position to accept that is correct on the facts at all, either in relation to National Grid Metering with the new and replacement contracts, or in relation to UMS. I am not in a position to accept it, in part because frankly it is nothing that is in this Decision; it is nothing that has been thought about, and it is not something that one would say is so intuitively obvious as giving a sort of advantage that the Tribunal ought to be in a position just to accept it unhesitatingly, despite those factors, it is simply not there. I understand it is a point that could have been investigated.

MR. SUMMERS: Thank you.

PROFESSOR STONEMAN: Can I just delay you a little further? There was a lot of evidence from Professor Grout and others arguing that sunk costs were the main barrier to entry.

MR. TURNER: Yes. I am going to come on to that. That is very important. I have got to address that.

I am just reminded on my right - and it relates to the final point I wanted to make on this - that, yes, there may be, perhaps in principle the idea of brand advantages, of course, the

competing meter operators who have come in - Siemens, United Utilities - are no slouch either when it comes to having high brand recognition. So, for that reason also it would not be intuitively obvious that National Grid has got some advantage.

But, allied to that is the final point on barriers to entry, which is that we made in our Notice of Appeal a cogent and reasoned attack on the idea by pointing out at para. 290 on p.255 in Tab 2, that it is not all one way that,

> "-- certain potential entrants are likely also to have competitive advantages of their own [to set against] any notion that National Grid is in a [net] favoured position".

We referred to the well-placed ability of electricity meter companies to expand into domestic meter provision. An interesting quotation from Ofgem on that point, from its own consultation, stated that,

> "Moreover, experience in the market so far suggests that the requirement for economies of scale and density need not be an insurmountable barrier for new entrants to the electricity metering market, and that it might be possible to achieve these economies through winning a contract with a major supplier ---"

Then at (b) the reference to the possibility of favouring in-house operations over external competitors, which in fact we have seen now as one of the developments in this market referred to in the agreed statement of facts - for example, Scotia Gas, I believe, is an in-house provider. That is referred to in the agreed statement of facts at para. 1 and 2 in Part 3. That paragraph, I believe I am right, is not addressed in Ofgem's defence at all. It has not been grappled with since.

So, the second leg of Ofgem's analysis of market power dominance is now concluded.

The point made by counsel for Siemens and CML that Dr. Williams did not address it in his report will take them nowhere. There was no substantive economic analysis in the Decision there for him to address.

That takes me to buyer power which is the big issue. The third leg. The essential question here is, as you are aware, whether National Grid was able to act independently of customer pressures - here customers praying in aid the possibility of competitors - to an appreciable extent when they were negotiating the Legacy MSAs. The Article 82 enforcement guidelines summarise the legal position as set out in the note at para. 21:

> "-- involving a situation where an undertaking's decisions are '*largely insensitive to the actions and reactions of competitors, customers and ultimately, consumers*'".

I am not taking a semantic point because you have heard taken against me the point that the ability to behave independently to an appreciable extent. Ultimately, it is a matter for your judgment, but we say that the Commission draws the line in the right place when it uses that phrase.

There are two main reasons why National Grid lacked dominance, as we say as part of National Grid's case. The first is that the gas suppliers could credibly threaten accelerated meter replacement - that is the sunk costs hold-up issue; the second is that National Grid could not protect itself against that sort of threat as a must-deal partner in a narrow sense by raising its prices to recoup as much as it could as if it was an unregulated company while this rip-out was happening because it was constrained by the regulated terms to confine its prices to the price cap levels. That is what we have called the regulated fall-back option which was available to the gas suppliers. Those features, in combination, structurally are extremely significant.

How are they dealt with in the Decision? The first of them - the sunk costs issue - is, as counsel for Ofgem pointed out - referred to in para. 3.76. It is not addressed with any reasoning. The second is not mentioned in the Decision at all.

So, what does the evidence relied on in the case that you have now been shown, and which is only cursorily and selectively cited in the Decision, show you? We rely on the contemporaneous assessments of the gas suppliers which I referred to in opening. I am not going to go back through all of that. What we have set out, if you look at para. 25(a) is two particular quotations from ----

THE CHAIRMAN: We are very familiar now with the documentation.

MR. TURNER: You are very familiar with that. But, that was how they perceived the balance of power. The gas suppliers concluded that Legacy MSAs were the most advantageous option to them because they provided lower prices than they could get. That is the table, madam, that you were referring to with the lines, showing the advantages to them of the Legacy MSA against the other alternatives which they would consider.

You have heard the direct witness evidence now from the senior negotiators on both sides of the deal. You have heard Mr. Avery explain under strong cross-examination that British Gas was in a strong bargaining position because of the credible threat to replace meters in a short period. Mr. Shoesmith - regardless of this point about whether it was five years or seven to nine years is immaterial (taking seven to nine years as the timescale within which these meters would be switched out) - regarded that as a wholly credible risk. What happened was that because of that dynamic, the terms of the deal were shaped in

negotiations by the demands of the customer. Price - perhaps the most obvious and important feature. National Grid offered a very significant reduction in . You have Mr. Avery's evidence in the In Camera part of the transcript. I will not refer to it, but you will remember the kind of accelerated replacement programme to which it was equivalent - which was very rapid.

In addition, British Gas' requests. We have these other features brought in: we have the band for operational flexibility; we have the glidepath; we have the contract term reduced from twenty to eighteen years; and we have National Grid offering - not insisting upon - a menu of different durations, and British Gas choosing the one that best suited it. Finally, we have enough free replacement to ensure that British Gas would not have to pay either for customer requested exchanges or policy. Nothing of that was challenged in cross-examination.

PROFESSOR STONEMAN: Not with this witness, no, but we did have another witness who said that given the amount of risk that was transferred, the effective price reduction was really minimal.

MR. TURNER: I am absolutely aware of that. That is the second point I am going to deal with. I fully recognise the importance of that. At the moment what I am talking about is the perceptions of the direct businessmen who were involved and how they saw it. Certainly, on that point, and insofar as the direct evidence of the businessmen is concerned, the language of transfer of risk is not something that you find in any of the documents on either side of the table. So, I just ask you to bear that in mind for the moment. It may be a characterisation ----

PROFESSOR STONEMAN: I would disagree with you. EDF discussed that in their decision to stick with the P&M terms. It is only a minor point.

MR. TURNER: No, you may be right, sir, but is that the quotation which is set out here in para.25(a).

PROFESSOR STONEMAN: The first few words, I think, "all risk sits with Transco", that need not necessarily refer to negotiating risk, it can be all sorts of risks with respect to ----

MR. TURNER: Yes, I understand that. Please do obviously remind yourself of that again. I anticipate that the submission that I am going to make on the risk, which is that in so far as risk is an issue, it is a different kind of risk from the one that I believe Professor Grout may have been referring to. I will come to that. This reference to risk was, I think, the negotiating risk.

That is the direct witness evidence. It is not challenged. So what is Ofgem's response? You have the argument that National Grid was an unavoidable trading partner because suppliers would have to continue taking the meters because of inertia from National Grid for a considerable number of years on the P&M terms. Our answer to that is as follows: that suppliers are dealing with National Grid for those meters on strictly regulated and price cap terms. It is not a situation where they can simply raise it and extract supra normal profits.

Secondly, although we are talking about replacement over potentially seven to nine, maybe eight years, from National Grid's perspective that is a very large chunk of meters with each year that goes by, and it would be wrong simply to say, that does not exercise a constraint. Of course it does and did.

The third point is the one that Mr. Avery brought out in his cross-examination, which is quoted in para.28(c) and which is in Camera, so I will not read it out. He presented the matter as being that, actually, there must – I will not read it out, you can see what he says there.

Then we come to the other gas suppliers. Ofgem's counsel told the Tribunal in opening submissions that while British Gas got some concessions the other gas suppliers did not manage to do so. That was wrong. National Grid did give a number of concessions sought by the other suppliers, and I have given the reference. It was set out in the written representations that were made in the administrative process. They achieved determination provisions in the contracts, the separation of new and replacement and Legacy as separate contracts, the original idea was that it would be all one contract, and the ability to elect to appoint a competing meter operator on a targeted geographic basis rather than the original proposal of a total across the board basis.

Then we come to the question of the depth of the price reductions and what that means. I will not go back to the table to which madam Chairman was referring, but you will remember it. This was attached to the British Gas board paper was an illustration graphically of the depth of the price reduction.

The table that was prepared for Professor Stoneman in response to the question on day 3, what does that tell us about the gas suppliers' options? What it shows is – and I will not necessarily open that up now, but you will recall the figure of £10.27 being the price per meter that the gas suppliers would get under the Legacy deal if they stick to the glide path over 18 years. In practice, we have seen from the gas suppliers' assessments before they entered into this that they weighed against that sort of price the price that they would get by

continuing on the P&M terms and replacing as fast as they could, to weigh against what became £10.27, and it was only if they found a benefit that exceeded the £10.27 that they were better off. They did not, and that was the sort of analysis that went into the British Gas tables showing that the Legacy deal was better from their point of view.

On an individual basis, meter by meter, you will recall the tables that were shown to Mrs. Frerk by myself, which merely set out the extent of the real price reductions net of business rates, and so on, that were extracted from National Grid.

Ofgem has sought to challenge the extent of these reductions in different ways. The first is to say, well, the ability to price appreciably above the competitive level, assuming it did not happen, that is only one criterion for assessing dominance, so do not put too much importance on this. I will accept that. I accept that you should treat that as only one criterion. However, the depth of the price reductions is still an important issue.

The second point: Ofgem says, when you are looking at the rental charge which ultimately is agreed in the Legacy deal what you need to focus on is the prices that were being offered by CMOs at the same time in the negotiations in 2002, 2003, not look at the P&M terms, or some blend which the gas suppliers were looking at of P&M terms and lower CMO terms over the course of time. As to that, we say as follows. We endorse and rely on Dr. Williams' evidence that the P&M price can be treated as the competitive price in this context for the reason he gives, which has been debated with him; but in any case, a point that the Tribunal may not have fully appreciated yet, the meter prices that National Grid was offering at that time were not appreciably above the prices being offered by the CMOs.

Like the CMOs, National Grid is offering a package – it is DCMs and PPMs – to the gas suppliers. National Grid is subject to the regulatory cross-subsidy, as you know, on the PPMs. The DCM prices did lie slightly higher. The PPM prices were significantly lower. A proper price comparison needs to take that into account.

THE CHAIRMAN: Mr. Turner, you, at a case management conference, specifically asked that the price comparison material which was filed by CML, initially comparing both DCMs and PPMs, should be limited to DCMs because the Decision did not rely on a comparison of PPM prices. That evidence had to be reserved having struck out all the price comparisons beyond the DCMs. So I am not sure whether you can go back on that.

MR. TURNER: I will not go back on it, but can I clarify. Let us clarify what was struck out and what remains in the case. What was struck out was an attempt by CML to show that their PPM prices were lower than National Grid's, because that was no part of the demonstration in the Decision. What remained in the case, and which remains in the evidence on both

sides because you will find it in the continued debate without any complaint, is whether, when you are looking at the credit meter prices you should take into account this regulatory cross-subsidy. Actually, CML says you should. Their evidence and their statement of intervention was it is the appropriate way to do it. What I would like to do is to show you their own price comparison on this issue. If you open up CB2 and go in it to tab 16, I am now going to refer to the case against me and I am told it also is confidential. It is at tab 16, CB2, p.1017.

THE CHAIRMAN: Should we go "in camera" then, Mr. Turner?

MR. TURNER: I think I can do it without going "in camera" and to save time. There is a table there in which you have CML's up to date comparison, this is the latest statement of its position in its skeleton argument. It only addresses the credit meters but it says you can look at it with a cross subsidy and without a cross subsidy – those are the two main columns. In understanding the comparisons that have been made, I am afraid you have to pick up Mr. Hoskins' witness statement at WS4, tab 10, and look at para. 11 on p.2162. What he does here in his (i), (ii), (iii), (iv) and (v) is explain the different bases on which he has made price comparisons. You will see that basis (i) is a comparison of new and replacement prices relating specifically to new meters – I am not interested in that one. Basis (ii) he is looking at new and replacement prices, as against the National Grid contract, for replacement meters. I am not interested in that one.

Basis (iii) is the relevant one because that is the prices under the Legacy Agreements against the CML prices under British Gas contracts, models on a like for like basis. Before you put it away you will see that (iv) is a comparison of the P&M prices, which I am not interested in, and (v) is the transaction charges for a CRE exchange, which I am not interested in. So you are interested in basis (iii), the comparison of the Legacy Meter credit prices.

Now, if you go back to CML's latest statement of the position, and you look at the "without cross subsidy" right hand side, you will see a comparison of the National Grid charge and the CML charge, and you will see there on the basis that CML say is right, because you have to allow for this factor, you will see the position, I will not speak to it. It is not consistent on that basis, which is part of their case, with saying our prices lay higher.

In addition to that, I will rattle through the following points. At some point (and I cannot remember when frankly) I went to a document referred to in the closing submissions at 35C, which was a draft letter from Mr. Astle of National Grid in which he was going to point out

that after adjusting for the impact of the prepayment cross-subsidy, these prices are very close to current market prices, so that is what National Grid was thinking at the time.

Then there is also referred to at (d), which I will not go into, the direct contemporaneous evidence from gas suppliers other than British Gas who tested the market at that time. They tested the market and you will see what they said, that the prices that they could get from the tender were not competitive with the revised Transco rates.

At first, that might be a bit of a puzzle, it may be explained and I say this, perhaps against interest, in complete fairness, British Gas had greater negotiating power with CMOs than they were able to achieve. But at any rate you have these other gas suppliers and they are saying that they test the market and find that the prices are lower. So that is on the price comparison that was put against me, that you look at it at the time.

Now, I turn to the transfer of risk issue that has arisen. Ofgem now says (based on Professor Grout's testimony) you should really view the price reduction as essentially a transfer of risk, and we have given the reference, it is para. 192 of Ofgem's counsel's closing submissions.

As Dr. Williams explained, because he was asked about this point as well, it is not right, and this is where we distinguish two kinds of risk. The first kind is what we have called here in this document "a moral hazard risk", namely that once you have struck the deal, and you now have the payment completion terms, the risk of the stranding which arose because the gas supplier can threaten accelerated replacement (under these no notice terms) goes away. So that risk then disappears, it is solved. The problem in the market place, in other words, which Ofgem was worried about as giving rise to that, that goes as well. I call it "moral hazard", perhaps loosely, perhaps incorrectly, but it is because the gas suppliers who were thinking of replacing do not face the full costs of the Decision that they are making. That is the risk which was referred to by EDF, which is the major lever used to beat National Grid down on the price. There is a different sort of risk, and I understand that, where you talk meaningfully about the transfer of risk, and that could be risk of a subsequent unpredictable market development coming along, for example, Government mandates, roll out of smart meters, who bears the costs now? The gas suppliers then are bearing that risk; that is a cost then that they are going to have to pay.

That is absolutely true. The Tribunal will recall that in the contemporaneous Board papers some of the gas suppliers did seek to assess these sorts of risks going forward, and they carried out sensitivity analysis to work out what were the chances that they would regret the Legacy deal. They ultimately made the Decision that they would accept that risk, and that

they were better served by taking the immediate across the board price reductions under the MSAs. So in that sense I accept that there was a risk. I say that the major constraint was a different kind of risk which led to those price reductions and that is the moral hazard risk.

PROFESSOR STONEMAN: I agree with you there are two types of risk. Under the Legacy MSA one of the risks that is being transferred is the risk that very large numbers of meters will become inaccurate, in that it counts against the glidepath, so that risk is now being transferred to some degree from National Grid to the gas suppliers, I think that was also in Professor Grout's mind - well, I do not know what was in his mind ----

MR. TURNER: No, no,

PROFESSOR STONEMAN: -- but I think he was thinking of those sorts of risks as well, and it also becomes a matter of where the customer requested exchanges appear in the system. So given the way that the MSA is set up, whereby there is an allowance, above which there is discretionary replacement, if it was the other way around, so that there was a number that could be changed – discretionary – and then National Grid undertook everything else as non-discretionary, the transfer of risk would have been different?

MR. TURNER: No, I understand that as well. I would say, of course, the glidepath is designed to have sufficient headroom to allow for all policy replacements to be carried out for free. There was a point I was going to come to perhaps later on but I will mention it now, it was assumed that there could be a risk if the amount of policy meters in a given year happens to rise above that number then you are stuck. Actually, as Mr. Keyworth recognised in his report (footnote 18) that is not right. There is a mechanism in the agreements, which he refers to there obliquely, which means that this glidepath number rises if National Grid specifies more policy exceptionally than that replacement number. So, let us take a situation (and I will give you the reference shortly) where National Grid says. "We wish to specify because a whole lot of meters have suddenly become inaccurate, far more than the maximum replacement number". What happens then is that instead of it being 980,000 meters which you have got for your free allowance it goes up correspondingly. That risk then is borne by National Grid.

MISS CARSS-FRISK: I am sorry. I wonder if we could be given the contract reference for that point?

MR. TURNER: Yes. I will come to that. (After a pause): Now, the next point is that Ofgem says that the P&M terms cannot be taken as weakening the bargaining position of National Grid because the gas suppliers could not be sure that the P&M price cap would not subsequently be lifted. That meant that they would think to themselves, "Well, if we stay

on the P&M terms National Grid could raise its prices against us". The point is not correct. As counsel for Ofgem accepted in argument with the Tribunal, the contemporaneous evidence uniformly shows that the gas suppliers treated as their benchmark, when they were making their minds up, the P&M contracts as a stable benchmark for assessing the value of the deals.

Professor Grout was asked about this. The reference is in para. 37 of the note. He clarified that he did not purport to argue that the gas suppliers had acted on any other basis. It was a matter of fact. What he did maintain was that the theoretical position was more complex because even under conditions of effective competition you could have some lee-way in which prices would rise. Now, whether or not one accepts that theoretical position - and we say for the reasons given by Dr. Williams you can reject it - the gas suppliers did not make that assumption.

That brings me to sunk costs. This is mentioned in the Decision. There is a reference to the argument at para. 3.76. There is no analysis. The debate happens here before the Tribunal. Ofgem, supported by Professor Grout, raised this new argument that National Grid's bargaining power was actually strengthened - or may well have been strengthened, by the fact that its costs were sunk. He explained the argument set out in his report as being that National Grid could be expected to reduce the price of its Legacy meter stock if it was under threat of replacement all the way down to very low levels, making it unprofitable for a competitor to match. The new entrants who were looking in would anticipate that sort of behaviour by National Grid and so they would be deterred from throwing their hats in the ring in the first place. So, he said that in an extreme example you would have no competition, and that would mean that the incumbent presumably would not be under this competitive pressure.

It is perhaps worth going to Professor Grout's testimony at Day 8 at p.62, beginning at line 23:

> Q Now, is it your opinion that what you call in para. 63 (last sentence): "… this extreme example" has any resemblance to the facts of the case? A. They do have a resemblance to the facts of the case.
>
> Q Because the gas suppliers in your view were not able credibly to threaten replacement with alternative meter providers? A. That is true, predicated on the fact that the facts of the case – if one takes this in the extreme economics we have here an example of where, despite what National Grid have said, we have an example of where the sunk costs would completely

prevent entry. In practice, in the real world, of course there is always somebody who wants to get into this market whatever happens, and they are willing to throw money at it. There is always scope for some competition so we have seen some, but in terms of the economics of the particular structure of this market, this is a case where entry deterrence would actually occur with sunk costs, and that is in complete contradiction to Dr. Williams' evidence; this is one of the big areas where we disagree".

Now, go forward from that to p.67 at line 16:

Q. -- Professor Grout, is the opinion that you want to express something different from the opinion which you have already expressed in your report, or the same? A. It's the same as what I expressed in my report, and contradicts what Dr. Williams has said in his evidence.

Q. It relates to the effect of a threat of post-entry aggressive pricing by National Grid using its Legacy meter stock. A. Yes. If you can sign the contract before the meter is put on the wall, National Grid will compete with the meter operator before the commercial meter operator puts his meter on the wall. The price will be bid down. It will be bid down to a point where National Grid's marginal cost is zero, the entrant's marginal cost is basically the price of the meter. National Grid will compete with the CMO in this context and it will be in National Grid's interests to keep repeating pushing the price down and they will go one step further than the CMO, and the CMO, even though they can sign a contract before the price is set, National Grid can undercut them".

Now, as the first extract shows, Professor's extreme claim about everybody being deterred did not precisely match the facts of this case because we know that people were not deterred. He fairly recognised that there was some competition. In fact, there was - because you have seen it in many documents - a genuine competitive threat which led to National Grid keeping the business on its Legacy meters by means of the Legacy MSA deals, but doing so only by sacrificing enormous value on the rental prices.

THE CHAIRMAN: Is there not a simpler point here - that there cannot be post-entry aggressive pricing by National Grid because everybody enters into long-term contracts. So, price is fixed in the contract that National Grid enters into before -- So, I am not sure how there is scope for post-entry aggressive pricing.

MR. TURNER: That is the point which we do rely on, which we picked up in the reply in reliance on Dr. Williams for - namely, that in the facts of this case the people who did compete from the outside did make contracts before they sank any investment, and in those circumstances they were protected by the arrangements which they made. That is the heart of Dr. Williams' argument. But, by the way, what is interesting about this is that although Professor Grout said there was a fundamental contradiction, in fact, as Dr. Williams eagerly drew to my attention, there was an agreement because Dr. Williams said, "What I would expect to happen in this situation is what did happen" - and what I think Professor Grout says you would expect to see as well. That is that the incumbent does keep the business on the Legacy meters - because they have got the advantage of the sunk costs (what Professor Grout referred to as the 'low, forward-looking costs of operating those meters'), but it does so at significantly lower prices. That is what one saw happening here. That is all that we are relying on. It happened.

THE CHAIRMAN: Perhaps that is an appropriate moment to break?

MISS SMITH: Madam, I hesitate to rise, but there is one point that, fairly, I do need to raise before the short adjournment, and it relates to para. 15 of the hand-up from National Grid as regards to barriers to entry. It would appear from that paragraph that as well as making the point that these matters were not raised in the Decision, National Grid is making a positive case, based on the evidence there set out, that these matters were not in fact barriers to entry. If that is the case they are now making, the Tribunal should simply be aware that Mr. Lee of Siemens' evidence, to the effect that these matters were barriers to entry, has been deleted. On sub-paragraph (b) the question of skilled labour was dealt with in para. 37(2) of Mr. Lee's evidence, which was deleted. The issue of advantages resulting from density of operations - that was in paras. 42 to 51 of Mr. Lee's evidence - was also deleted.

THE CHAIRMAN: Thank you, Miss Smith. We will resume at two o'clock.

(Adjourned for a short time)

MR. RAYMENT: Madam, just before Mr. Turner gets started again, I wonder if I might just raise a small matter with you. You started as an aperitif to your lunch with Miss Smith making a complaint and now, as your digestif, I am afraid you have got me making a small complaint, and it is simply about the price comparison that Mr. Turner took you to before lunch. I think, judging by your reaction, you had very much the same reaction as we did about that point. I wanted to make sure the Tribunal is aware of how we deal with the comparison issue in the annex to our skeleton, where we make the point that if Mr. Turner is going to rely on the DCM comparison with the cross-subsidy removed which favours his clients then

our comparison involving the PPM is also relevant, we say, and therefore, in those circumstances, it is not open to him to rely upon the comparison with the cross-subsidy stripped out in relation to DCMs. The whole point is to understand that in the annex to our skeleton we were simply putting in the comparison with the cross-subsidy stripped out just for illustrative purposes and we do not accept that that is the correct way to deal with the matter. It is para.7 of the annex that I particularly invite your attention to.

The other point, of course, is the indexation point that CML's prices do not go up on an index basis, whereas National Grid's do.

THE CHAIRMAN: Thank you, Mr. Rayment. Mr. Turner?

MR. TURNER: I may find in a moment the reference to where they said it was the appropriate basis, but I will push on. Madam, how long is the Tribunal willing to sit for? Is it a four o'clock or a 4.30 day?

THE CHAIRMAN: We will sit until 4.30 if that is how long you need to complete your submissions.

MR. TURNER: I will go as quickly as the subject matter permits. I have only one or two final points to make before we turn to the question of abuse. The first is to pick up one point on Professor Grout's view about the importance of sunk costs. He did recognise in the real world competitors do come in and he recognised that in this situation some people have come in, and they do so for all sorts of reasons. He was absolutely right to do that and I wanted to pick up on two reasons why that is the case in this context, and they are set out at 39(a) and (b) of the note. The first is something that Professor Grout himself referred to in his report at para.37, which is that the CMOs have what he described as an "obvious and relatively constant source of work available to them anyway", which is the failing meters, or the policy meter replacements, "to provide a steady flow". He said an "obvious and relatively constant source of work for new entrants". Indeed, that was the basis, as you have seen from some of the emails on which, at least in the early years, the Ofgem officials considered that new competition would be getting its toe-hold in the market, allowing the market to grow organically.

The other thing is this: that Professor Grout was also right to say that people have all sorts of reasons for entering a market. I wanted the Tribunal to recall that you had some evidence on that. In 39(b) we refer to Mr. Southgate, who I think is the Siemens witness, and that is a non-confidential quotation from his evidence, where he points out that this was going to be from their point of view a springboard. So they had that motivation.

Where do we stand then? The gas suppliers could and did credibly threaten accelerated replacement. They did extract severe concessions, and Dr. Williams and Professor Grout agree on exactly what happened in economic terms to lead to that coming about. I have added that yesterday counsel for Siemens and CML took what we considered to be a bad point on the issue of dominance in the sense that he appeared at times to be arguing that our case was that if there was competitive framework there could not be dominance. I want it to be plain, we were not arguing that, we were relying on the balance of the bargaining power and the concrete evidence which I have referred to.

Finally, the modified greenfield approach: this was something canvassed by madam Chairman, which was then picked up by Ofgem and developed in their closing submissions. The argument there is that when you are assessing whether there was market power or not, you should leave out of account the fact that National Grid was subject to the price control terms on the P&M contracts, it should be left out of account in an assessment of their dominance.

THE CHAIRMAN: If it is the case that the price control is only imposed because of their dominance?

MR. TURNER: If it is the case that the price control is only imposed because of their dominance. We have not yet had the reference to the condition under which that was imposed. I will take that for the moment as the working hypothesis. Nonetheless, as you are aware, that is an approach which has been applied in the telecommunications context in relation to whether you should impose *ex ante* regulation, a price control in advance of behaviour by a company, under the common regulatory framework. When you look at the argument, it can be seen not to be applicable in this context. If you open up the authority that you were taken to yesterday in the new Ofgem authorities bundle, tab 3, that is the first *Hutchison 3G* case, 2005. The key part of the discussion is in paras.97 and 98, and I focus again on what was said in para.98, which you will find on p.49:

> "This point is said to be developed in paragraph 23 of the Decision:
>
> 'The purpose of a Greenfield approach is indeed to avoid circularity in the market analysis by avoiding that, when as a result of existing regulation a market is found to be effectively competitive, which could result in withdrawing that regulation, the market may return to a situation when there is no longer effective competition. In other words, any Greenfield approach must ensure that the absence of SMP [significant market power] is only found and regulation only rolled back where

markets have become sustainably competitive, and not where the absence of SMP is precisely the result of the regulation in place.'

In other words, a potential regulated person cannot claim that it does not have SMP because regulation has procured a situation in which it no longer has it. So long as it is regulation which is bringing about competitive outcomes, the markets are not competitive independently of that regulation."

Then critically:

"It follows that the potentially regulated person cannot say that it does not have SMP because the threat of regulation means that it does not have the necessary power. That would be circular and illogical. OFCOM relied on this reasoning."

The issue of circularity and the illogicality which arises from it is applicable when you are talking *ex ante* regulation because you saw off the branch that you are sitting on if you are thinking about whether regulation should be imposed on the company looking forward. It does not apply when you are thinking of the *ex post* competition rules and you are looking back and trying to assess whether a person possessed market power at a particular point of time in the past, and this is something which is explicitly recognised, that you must look at the regulatory constraints as well was all other parts of the factual context when you are assessing market power in the OFT's Guidelines on Assessment of Market Power, which you will find in bundle A3 at tab 55, near to the end, on p.1736, which is a section dealing with economic regulation. What the OFT does here is to say:

"In some sectors the economic behaviour of undertakings (such as the prices they set or the level of services they provide) is regulated by the government or an industry sector regulator, and an assessment of market power may need to take that into account. Although an undertaking may not face effective constraints from existing competitors, potential competitors or the nature of buyers in the market, it may still be constrained from profitably sustaining prices above competitive levels by an industry sector regulator."

Then it goes on:

"However, that is not to say that market power cannot exist where there is economic regulation. It is feasible, for example, that regulation of the average price or profit level across several markets supplied by an undertaking may still allow for the undertaking profitably to sustain prices above competitive levels … and /or to engage in exclusionary behaviour of various kinds."

The reference there to the footnote, you will see on the left hand side of the page, is to the *Napp* case, where indeed it was the case that the undertaking concerned accused of engaging in exclusionary behaviour said: "We are regulated under the PPRS scheme, and the Tribunal did not ignore that, it took it into account as a relevant fact, but it pointed out that the regulation was spread across a whole range of the undertaking's profits, and it did not directly control the prices in the market with which we were concerned. So it was factored in but on the facts it was not sufficient to get the undertaking home in its case.

That is all I wanted to say about market definition and market power.

I am sorry, I will just give you the reference, in relation to Mr. Rayment's statement, in Mr. Hoskins' witness statement, which I do not ask you to turn up now, WS4 tab 10, p.2162 at para. 11, he sets out his tables on the various bases – basis (i) to basis (v) – and he is seeking to present on a like for like basis a direct price comparison between CML prices and those published by National Grid. I have taken account of both RPI and published details of the cross-subsidies.

THE CHAIRMAN: We will look at that and make up our minds.

MR. TURNER: Yes. Abuse – both of the principal parties, i.e. National Grid and Ofgem, agree that the correct way of analysing whether you have abusive conduct is supplied by the *Hoffmann-La Roche* case which involves the well known test set out in the Decision at para. 4.6. You ask yourself whether the conduct involves recourse methods different from those which condition normal competition. In other words, at that stage you are asking yourself whether the conduct in question is in some way artificial, is not competition on the merits, and "artificial" of course is the phrase which is attached in the Decision repeatedly, to the structure of the charges in the MSAs.

Then you consider the effects on competition of the conduct in question and we accept without any doubt that these effects need not be actual effects, they can be likely effects on competition as well.

Normal competition – how does it fit into the analysis? We say it is an essential issue that needs to be grappled with, it is the benchmark issue, because if you skip over that and you are merely asking yourself: "Is this a case where I have a dominant firm, and I see that the ability of competitors to get into the market, or their profits are reduced, then it seems pretty obvious that perfectly benign conduct, which amounts to competition on the merits, could be penalised, or at least that it would be said that is in principle abusive, and now you go and justify it objectively. We say that that is not the way Article 82 is meant to work.

Before you turn to engage in some analysis of that kind you have to have some benchmark

against which you are measuring the conduct and ask yourself, in the conduct of this industry, "am I looking at competition on the merits?"

The case law under Article 82 in our submission fully confirms this in every way. I gave you in opening the example of predatory pricing because it is quite close, as it is a pricing issue, to the current case. Plainly a dominant firm's pricing behaviour cannot be said to be anti-competitive merely because of effects on competitors. You can always stimulate more competition in the market place by charging higher prices, but the law says that you have a cost benchmark in order to decide whether you have crossed the line and you are departing from competition on the merits.

The same is true in all of the other areas, take one other example: refusal to licence your intellectual property. Again, if a firm refuses to licence intellectual property then the extent of competitive activity may be reduced, but the case law only requires such licensing to be undertaken in limited circumstances which are laid down, such as where you are denying the emergence of a new product, etc.

Similarly, and now we come back to an area closer to home the community case law about the granting of discounts or rebates, articulate criteria for deciding what is and what is not competition on the merits. I go to this because it was said: "No, that very case law shows you the opposite", so if the Tribunal would please pick up the *British Airways*' case in bundle A5. We go first to the Advocate General's opinion at tab 76, at para. 24 on 3275. She records that:

> "… a dominant undertaking is entitled, according to consistent case-law, to protect its own commercial interests if they are attacked, and may also take such reasonable steps as it deems appropriate to protect them. In particular, it may use the methods of normal competition in products and services in the sense of competition on the merits; however, a business practice which deviates from normal market behaviour and is capable of weakening existing competition is an abuse within the meaning of Article 82 and therefore prohibited. Not every kind of price competition is therefore permissible under Article 82."

So, pausing there, I would only add what is normal competition involves looking at the industry you have before you. She then went on in para. 25:

> "In the area of rebates and bonuses it is particularly clear that, in individual cases, it is difficult to draw the line between legitimate conduct and the prohibited abuse of a dominant market position."

So there she recognises it is difficult to draw the line, but it is premised on the need to draw the line.

If we go to paras. 47 and 52, beginning on 3277 – I am not going to read all of this out – she begins by saying:

> "Even if the case law cannot exhaustively define cases of rebate and bonus schemes with foreclosure effect, it can supply indications of when such a foreclosure effect will be present *in the normal course of events*".

Here in interpolate only to say that she is using foreclosure in the term in which I am using it - meaning anti-competitive foreclosure -- behaviour which has crossed the line. She refers to three aspects which are particularly relevant in determining, in accordance with the case law, that the rebates or bonuses granted by a dominant undertaking represent more than just a particularly favourable market offer. Those are set out at paras. 48 and 50. Paragraph 52 is the third criteria. Some of these will be familiar to you.

So, counsel for Siemens then appeared to question - he was basing himself on this and on the court judgment -- whether any kind of benchmark is in fact necessary before you are into the territory of anti-competitive foreclosure. He went to the ECJ judgment at Tab 84 in the same bundle, A5, at pp.3794/3795. You will recall him reading you the passage down to the end of para. 69 on p.3795. But, what he therefore did was stop at the crucial point because, then, beginning in para. 70 the court explains that the case law gives indications as to the circumstances in which discount or bonus schemes will be found to give rise to exclusionary effects - that is, the anti-competitive foreclosure - and before you come on to the issue of objective justification. You can see that because in para. 70 the court introduces the paragraph with the phrase, 'With regard to the first aspect the case law gives indications' as to the cases in which you have the exclusionary effect. The 'first aspect', if you then track up the page, is referring to the exclusionary effect. You see that in para. 68. Then para. 69 says that having done that, you go on to whether there is an objective economic justification.

So, at the first stage it is referring to the case law as helping to draw the lines, the boundaries and to decide when discounts or rebate schemes have the character that are exclusionary. That is then developed in paras. 71 through to 77 where what the court does is apply the tests that were developed in the *Michelin* case. You see, if you also look at para. 63, the prior reference to the Michelin case is providing the guiding principles which are then applied in the British Airways case. In the third sentence of para. 63,

"In that case, the court found a series of factors which led it to regard the discount system in question as an abuse of a dominant position ----"

Then those features are set out.

So, we say that is the way in which this case, and indeed all of the Article 82 case law, should correctly be interpreted. Once you lose the idea of some line for dividing legitimate behaviour which harms competitors and illegitimate behaviour you are adrift on an open sea.

In his opening submission counsel for Siemens and CML also argued that you should not get too fixated on the concept of normal competition which is what we have been referring to as this benchmark. He took you to a passage from Chapter 5 of Professor Whish's textbook on competition law. That was meant to support the proposition that the concept was too indeterminate to provide a coherent definition. We have copies of the preceding pages in that chapter. (Same handed) When you look at what Professor Whish was saying with the relevant pages there as well you will see that he recognises an essential need for the benchmark. On p.189, under the heading 'The Article 82 controversy' there is a paragraph which begins: "It is not controversial to say that Article 82 is controversial". Near the end of that paragraph he picks up:

"… by its nature, the application of Article 82 involves a competition authority or a court having to decide whether that behaviour deviates from 'normal' or 'fair', or 'undistorted' competition, or from 'competition on the merits', none of which expression is free from difficulty.

Transgression of Article 82 has 'serious consequences: fines, damages claims, the imposition of remedies, such as a duty to deal, raise or lower prices, and even the possibility of a structural change to the dominant undertaking. It follows that there must be rules that are reasonably certain in scope, and administrable in practice that enable undertakings and their professional advisors to know on which side of legality they stand; competition authorities and courts also need to know what is lawful and unlawful. ... It is a truism that competition policy is in favour of firms competing, on price, quality and innovation; and that dominant firms should compete – and be able to compete – as well as non-dominant ones".

So, in fact, Professor Whish was not saying that you cannot, and should not, think about there being a benchmark. He explicitly draws attention to its importance.

Counsel for Ofgem and counsel for Siemens and CML then went to another case - the ice cream case - *Van den Bergh*. They used that to suggest that that was a case in which the

court had reasoned without reference to a benchmark of normal competition. That is incorrect. We can either do this in the bundle, but I can take this from my note at para. 53. The point is that the need to consider whether the freezer cabinet exclusivity that was a requirement imposed on retailers -- The point made here is that everybody agreed that the question whether the cabinet exclusivity requirement was normal competition was a relevant issue. You have the Commission which argued

> "HB's practice of tying the cost of the freezer cabinet to an exclusivity clause when there is no objective link between them is at variance with conditions of normal competition for consumable items".

So, it is talking there about the circumstances of that market and whether an imposition of an exclusivity arrangement for the cabinet could be viewed as normal competition in the context of that particular market.

THE CHAIRMAN: What was the benchmark against which they compared it then, providing a cabinet for a charge and then just allowing anybody's ice cream to be put in it?

MR. TURNER: It would be, in other words, the absence of such a feature, because it is that feature ----

THE CHAIRMAN: Was there anybody actually in the impulse ice cream market who was doing that -- who was selling freezer cabinets or providing them on a rental without having the tie-in?

MR. TURNER: I am not aware of that, but that takes us on to the second point which is taken against me, which is the standard practice point. I will come on to that in just a moment. Before turning to that, I will mention two issues: the first is that the same sort of reasoning about whether it is normal in the context of the market and the product or service you have before you also is a feature of the *Distrigas* case that counsel for Siemens referred to where you have a long term agreement for the supply of gas. The supply of gas is very different from a case such as we have before us where you have got a long lived asset and the sunk costs that need to be recovered over time through rental payments. A long term agreement, therefore, in this sort of case, perhaps approximating to the life of the asset or the period over which you are recovering your investment, is an altogether different matter from the long term agreement for the supply of units of gas for many years in the future.

The court in *Van den Bergh*, I also point out, also accepted and applied the two stage *Hoffmann-La Roche* test. It found that the practice of freezer cabinet exclusivity was not normal competition.

I pick up the point about the standard practice in the industry in the next paragraph, because, madam Chairman, you are right, in that particular case it looks as if making freezer cabinet exclusivity arrangements was a standard practice. Everybody was, or perhaps almost everybody, was doing it. The dominant firm then says, well, we should be excused, or you should not regard this as abnormal competition because we rely on the fact that other people are doing it. What the court does is then to reject that as a justification. It says you cannot rely on the fact that it is a standard practice, but what it is not doing is departing from there being any benchmark of normal competition, only allowing a dominant firm to rely on the fact that a practice which is found to objectionable or non-normal has become standard in the industry. We do not in this case suggest, to bring it home, that the Legacy MSAs should be treated by yourselves as normal competition because they are a standard practice. That is not National Grid's case, or how we have run the point on normal competition at all.

The type of PRCs and the structure that you have in the Legacy MSAs is certainly different from what you find in the CMOs and the National Grid new and replacement contracts, but they are nonetheless in line with normal competition – that is what we say – because there are reasons for the differences between the exit charges that you have in the Legacy agreements on the one hand, and in the new and replacement agreements on the other hand. Those differences make no difference whatsoever as respects foreclosure. They provide for at least the same amount of replacement incentives – and we come on to the economic point that has been raised – as in the case of a straight sale, if you imagine that these items had actually been sold to the gas supplier. So we are not running a standard practice kind of case at all.

Turning then to the other principle, which is the assessment of actual likely harmful effects, sometimes the position is obvious, and you do not need an analysis, but other kinds of cases where it is difficult to draw a line, and often pricing cases fall into that category, you sometimes do need to have a counterfactual to try to establish how competition would operate once you have stripped away the features that you say are objectionable. The necessity for a counterfactual analysis, in our submission, is clear from the Commission's recent enforcement paper. We make the point in para.56(a), and I will not dwell on it, that it is a more authoritative document than the staff discussion paper from 2005. Both of the documents contain the same disclaimer about not speaking for the Court of Justice, and so forth. The former is a document published for discussion purposes and the latter is a formal Commission communication. Where they talk about the case law they are both purporting, with their references to the cases, to represent what those cases tell you.

The questions for the Tribunal at para.57: when you apply the principles to the facts of our case there are three questions which arise. Number one, in the context of the industry before the Tribunal, are cancellation charges, exit charges of some kind, consistent with normal competition? Number two, has Ofgem demonstrated in its Decision that these non-age related charges which you have in the Legacy MSA depart from normal competition, competition on the merits? Number three, has Ofgem succeeded in showing that these charges have an actual likely adverse effect on competition? Specifically, they try to do that by means of their age related counterfactual. Alternatively, does their analysis of the effects on volumes and prices and on consumers, which they also engage in, give you the necessary proof? We think that is a convenient checklist.

I turn to the first of those points, and I think we can take it quite quickly, paras.58 to 64 of the note. Counsel for Ofgem accepted that age related charges are not abusive, and that is a correct concession. I have drawn attention to the fact that at one stage counsel for Meter Fit seemed to suggest that the Meter Fit contract applied exit charges in more limited circumstances than under the Legacy MSAs in the sense that you would only have them in relation to what he called "dumb to smart" replacements, but the note that was subsequently handed up by Meter Fit corrected the point, rightly, and made clear that exit charges are payable whenever a working meter is replaced by another meter operator as permitted under the contract. The doubt that remains for all these contracts, which was explored yesterday, is that the contracts do not appear to specifically make provision for a pure like for like replacement, as opposed to functionality exchange. There is then a question mark about whether any of the parties envisaged that, or what happens if you try to carry one out. Professor Grout accepted that exit charges are a normal feature of competition in the market. That is both in his report and in cross-examination. We take it that the idea that the use of PRCs or exit charges is a departure from normal competition in this market is not pursued.

The next question is whether the exit charges which you have got in the Legacy MSAs are consistent with normal competition, even though you have not got age related charges. What this boils down to as far as we can see is the claim that while we could have introduced age related charges if we had assigned ages to all of the meters in the Legacy stock. We were not permitted to introduce what we did with the gas suppliers, which was a glide path coupled with the flat rate declining charges and the below line rentals, what is called the Take-or-Pay provisions. That claim, in our submission, does not have a solid basis. The way we approach it is to remind the Tribunal of the circumstances in which this

was done and the way in which this structure was arrived at. The circumstances are that you had a very special one off problem of contracting for the Legacy stock at this unique time, and you have millions of meters of differing types, ages and conditions.

The second point is that the charging structure which had passed into the contract was shaped by the needs and requests of the customers, the gas suppliers.

So far as the PRCs are concerned, National Grid did, as Ofgem rightly points out, originally think about an age related approach. It was rejected and you have seen the reasons, the internal thinking, as to why it was rejected. It was not just because the company said to itself, "We do not have reliable data on all of these meters", it was also because of the complexity and costs that they thought would attend operating this sort of approach. I have set out in para.67 quotations which you are probably now well familiar with, including at 67(a)(ii) the internal thinking that the approach of a Glass's Guide is overly complex and will struggle to develop systems to implement it.

You have the same view about that from the other side of the table which was Neil Avery of British Gas, and at 67(b)(ii) the point that he made, which I believe was not questioned in cross-examination, that it would have caused particular problems in relation to what he calls the "debt drive exchanges", the customer requested exchanges, where it would have required an individual judgment to have been made about whether the benefits outweighed the costs for each individual customer, when they wanted to swap them on to a different kind of meter, a pre-payment meter, and he said that would not have been workable.

The third point is that that would have been resisted by British Gas because of the difficulties in some of the areas which they operated in, including the Meter Fit area in particular, old meters and policy meters were very thin on the ground. So if you adopt a strict approach like that it could have caused difficulties for the entrant, and higher costs.

So far as the BLR band is concerned, again it is Mr. Avery's evidence that this was introduced to allow operational flexibility and even that British Gas tried to increase the size of that band during its negotiations.

The glidepath mechanism was introduced at the request of British Gas and, for the reasons we give in para. 80, which you will also be familiar with, the Legacy MSAs were viewed as being significantly more conducive to efficient and flexible patterns of meter replacement on the ground.

What did the economic experts say about that? (para.71). Dr. Williams pointed to the need to take these features into account and, in particular, transaction costs and economies of

density when you are assessing whether an age based or an average approach would be optimal.

Professor Grout accepted in cross-examination the relevance of these features, and all the points are set out there. The ultimate conclusion which he was interested is in what direction, when you take account of all these relevant factors, from an economic point of view, do the economic forces push you in? He had said in his report that they had pushed towards the age based. I put it to him that: "If you take into account these other things, which were not mentioned in your report, it could push the other way?" I believe at the end of the day his view was: "I still believe that they would push towards the age based approach." But nonetheless, they are relevant factors, they are factors which you do take into account when you are looking at this problem from the outside, from the position of an academic economist, as well as when you are a business man thinking about this problem, and they did push, in my submission, in the direction in which they ended up, which was the Legacy MSA based structure.

So for those reasons, a sort of "bottom-up" approach, we say that the structure that we find, which is now the main issue in this case, was not objectionable.

We then come to the other approach, which is the question: "Can you say that the replacement incentives which you have, using this structure, are harmful, because if you compare it with something like the sale of the meter to the gas supplier, they have a reduced incentive to engage in replacement, to allow their meter operators to replace the meters.

I believe it is common ground between the economists in the case that a contract which at least matches the replacement incentives that you find under ownership is benign, and it cannot be said to foreclose competition in the anti-competitive sense of foreclosure. That was the position of Dr. Williams, and you read his report and he was questioned about that.

Professor Grout also accepted that replacement incentives under sale by way of upfront payment were normal and our position is that the exit charges which you find under the Legacy Agreement meet that condition.

There are ways in which you can say that the incentives which the gas supplier has in a sort of long term rental agreement with these provisions differs in various ways from ownership, but the question from our perspective is there may be some differences, but ask yourself what direction do they push in? We say that they generally provide for greater replacement incentives than under ownership and therefore would end up giving more work to CMOs than the CMOs would get if the gas suppliers had been sold the meter stock.

We set out a further explanation of the position in the note which was handed up before closing submissions by counsel for Ofgem, I do not know if you have a copy of that?

The intention behind this note was to take up the valid point raised by Professor Stoneman and madam chairman, namely, it is all very well to talk about a PRC when you have an individual meter, and if it is replaced early then the PRC compensates for the lost revenue that you have foregone, you have a funny kind of case here, because there are three different situations at least that you might find yourself in. You might find, if you are the gas supplier, you can replace this meter and pay no charge. You might find that you are in the BLR band and then you pay rental for one year at least foregone, or for every year that you remain in that band, and if you dip below that you then pay the PRCs on the basis set out in the contract. The intention behind this note is to look at each of those situations and see, first of all how they work, and then to ask: "What are the replacement incentives that arise in these different cases?"

So para. 10 and following is considering the position when you are in a position where PRCs are due. You have dipped down so far. You might not say it is because of this particular meter, but now a PRC is going to be due because you are below the below-line rental band. What happens is: the way that the contract works is that the glidepath is then adjusted so that you have a lower rental obligation in future years, but it is a flat line all the way to the same ends, the 18 year point in the case of the credit meters.

The graphical illustration is meant to show you that what the PRC amounts to is not an amount referable to the income you have lost on additional meters replaced just in that first year, it is meant to take account of the fact that the glidepath has come down and so for future years, and on p.4 of the note, you see it in my copy – if yours is in colour – in red on the bar chart. You have also lost a stream of rental income because of this adjustment to the glidepath going forward. So the amount that you get under the PRCs is simply the amount needed to cover that lost revenue which you will no longer receive because of the movement in the glidepath. You apply it to the numbers of meters which are removed in that first year. So in this example, if you have lost £10 you apply it to the four additional meters that are taken out in that first year, it works out at £2.50 a meter. That is a form of compensation, it puts you back in the same position, given the way the glidepath moves downwards. It is said at the end of that section, (para.14) that because of this from the point of view of the gas supplier the value of the rental saving and the value of the PRCs cancel out. So the incentives faced are therefore the same as under ownership.

The second scenario is the BLR band. Here you pay the same amount that you would pay if the minimum volumes committed to were still in place. So, again, it is simply putting you in the same position you would have been in had the rental agreed to be committed to been paid. Footnote 9 says that that position will continue for each year that you remain in the band. But, you are not put in a better position.

Finally, the free glidepath allowance is perhaps the interesting one. I made the point at the outset that partly as a result of the pressures imposed by Ofgem, which you saw, the glidepath is not set so as to allow you just to do your policy replacements and your functionality exchanges. There is the headroom. One can argue about how significant that headroom is. From National Grid's perspective it is a lot of meters a year - at least the 130,000 figure you have thought about. In relation to this you can take these meters out entirely without charge. You avoid the rental that you have to pay. There are cheaper meters in the market. You can replace. That creates incentives for that significant chunk which are even greater than ownership. So, to the extent that you are talking about a divergence, you are now talking about something which pushes quite considerably in the other direction towards greater replacement incentives. I am aware of the time.

Ofgem's counsel have suggested that the analysis is undermined because of the possibility of further rentals being paid at the end of the term. You might come to the end of the glidepath and you are still there, sitting with meters in place, and under the Legacy MSAs, to the extent that is true and nothing happens, you continue paying money.

We say that insofar as it is some kind of criticism which is meant to imply that there is foreclosure resulting from that situation, it is a bad point. If it has any effect on replacement incentives - the idea that when you are looking forward as the gas supplier that at the end of the term I will have meters in place which I will still be paying rental on, they will think to themselves, "The PRC which I need to pay to get out of this contract on these meters relates to, let us say, six remaining years (the contracted term). So, even though the meter might last another ten years before it pegs out, the extent to which I am paying increased rentals beyond the contracted term -- I can avoid those rentals by paying the PRC referable to the six future years". So, to that extent you have greater incentives than you would do under a condition of ownership. That is not a foreclosing feature.

THE CHAIRMAN: Do you accept that in assessing the amount -- Let me put it as an open question: In assessing the amount which National Grid decided it wanted to protect by these PRCs in terms of the minimum rental commitment, was any account taken of the fact that the value of the contract, as Professor Grout would have put it, might be greater than the

minimum commitment, although obviously it could not be less? (After a pause): For example, did you say, "Oh, well, we are likely to still be getting rentals on meters more than eighteen years old. So, we will take that into account when considering how much of our rental stream we ought to be protecting"?

MR. TURNER: Yes. I am fairly sure, without turning behind me, that the answer to that is, "No" because the assumption is that under the glidepath you are going to actually find the people using up the replacement incentives all the way until the end, so that by the end of the glidepath they have replaced everything. But, secondly, it is not the value of the contract then that you are considering. It is a value arising after the contract period which you would have in mind rather than the value which you would be trying to preserve through the contract, through the commitment which would arise. I will check as a matter of fact -- (After a pause): I will be prodded if I am wrong on this. I think in relation to the credit meters the expectation was that all the credit meters were going to be replaced. In relation to the PPMs there is a rather different situation. You will remember there the glidepath is seven years and the average life is longer than that - it is ten years. So, I think it was assumed that the actual rentals would be for ten years in the sense that the gas suppliers would want to continue with the rentals of the PPMs for longer than the seven year period - bearing in mind, of course, that these are also subject to the cross-subsidy and they are cheaper than the ones which are available elsewhere.

PROFESSOR STONEMAN: This is not the time to get back into a discussion we had before, but this paper of yours - Ownership Incentives Under The Legacy MSAs -- In a sense I have last word on this in the context of my two colleagues.

MR. TURNER: Yes, you do.

PROFESSOR STONEMAN: But, could I say that what you have written down I do not disagree with, but you have not gone far enough. You may remember that Dr. Williams said that whether to replace is dependent upon profitability; when to replace is dependent upon changes in profitability. That is the arbitrage condition.

MR. TURNER: Yes. Yes.

PROFESSOR STONEMAN: Now, the arbitrage condition comes into play when the price of getting out of the contract is changing over time.

MR. TURNER: Yes.

PROFESSOR STONEMAN: You have not taken any account of that. Once you introduce the arbitrage condition, which is dominant to the ownership or the profitability condition, then you will get a different result. So, although what you say here is strictly correct in its own

terms I do not think it is correct -- I do not think it is completely correct. It is the truth, but not the whole truth.

MR. TURNER: I see. In terms of how to deal with that at this stage, sir ----

PROFESSOR STONEMAN: I just thought I would let you know how I was thinking about it.

MR. TURNER: No. No. No. Absolutely. It is rather difficult for me. The question is how you would like that addressed or whether there is an issue on which you feel that more material is needed from either party.

PROFESSOR STONEMAN: No. I think you have put in your evidence and we have to consider it appropriately.

MR. TURNER: Yes. I understand. (After a pause): The material point, sir, I absolutely understand. If there is a feature which has not been taken full account of in the note, still one comes back to the question whether it affects the specific question which the Tribunal is confronted with, which is the issue of foreclosure of competition. In that circumstance we say that the real issue for you is the decision whether to replace which is faced by the gas supplier as opposed to the decision of precisely when to replace.

PROFESSOR STONEMAN: We hear the point you make.

MR. TURNER: Yes. So, the other points on this which are at paras. 77(b) and (c) of the note are the points, first, that the free allowance does mean in practice that few, if any, meters are going to be there in situ at the end of the term -- Well, here we are talking about the credit meter side. Thirdly, the point, "What are you comparing this with?" The right comparison now is that you have to think about the situation that Ofgem offers you, which is that you have got age-related charges under a long-term rental agreement and you imagine that each of them also allow the possibility that the rentals might continue after the end of the committed term. So, a meter can become free to replace either under the Legacy MSA or under this different situation, and for whatever reason you might find that the meter stays in place and the decision of when to replace arises in each of those two situations.

So, that is all I wanted to say about that.

We go on at para. 79 of the note to refer to one particular criticism which was made of the analogy with the straight sale. This is para.84 of Ofgem's closing submissions where they said that even if an additional meter sought to be replaced was on the replacement schedule as not fit for purpose it might, if the glide path was sufficiently exceeded, incur an average PRC of £57 regardless of the age of the meter itself. There are a number of points there. First, I do not want the Tribunal to think that that figure of £57 has any relevance. That is the figure which is for 2004, the first year of the contract only, and you are aware that every

year after that it is a smaller figure. Using that figure, as Ofgem do here, is inappropriate anyway.

Second is the point which I referred to before lunch, that the glide path cannot be exceeded owing to an increase in the number of policy meters that National Grid specify. I have given you here a reference to where we put it in the written representations made to Ofgem about it. We have never seen it as a matter of dispute. Mr. Keyworth refers to it, as you see from footnote 2, in his report. The reference in the contract which my friend wanted, and I can give to you, is bundle CT1, tab 4, p.788, schedule 7, part 2, section 3, para.13(a). It is blindingly obvious to anyone who knows the contracts the way that we do!

Other than that, the criticisms which were made by Ofgem in the closing submissions yesterday were not developed in oral argument. In large measure, as far as we can see, they are seeking to make the point that there are many ways in which you can say that a long term rental is different from ownership. There are perhaps numerous ways in which you can say that is the case, but the real question is whether you can say that the replacement incentives arising under our sort of structure lead to these foreclosing effects. We have set out a more detailed response to Ofgem's written points in our own written points which you will find tucked at the back of this set of closing submissions.

Estate management concerns, as we call them: the only other issue relating to normal competition, we think, arose from Professor Grout's point that under normal competition he, as economist, would expect there to be an age based structure of exit charges on the basis that older meters are less valuable than younger meters. You will recall the debate about this, and you will recall the reference to the figure in Mr. Way's witness statement. Would you, please, perhaps turn that up. It is in WS5, tab 20, p.2921. Professor Grout is absolutely right, of course, to point out that for these meters prior to, I think, 1995/96, you see what, in our submission, is a slightly higher, but higher rate of inaccuracy than in the meters whose vintage is 1996 forwards. So to that extent there is a point. On the other hand, look at, say, the meters between 1981 and 1995, or look at the meters between 1996 to 2006. You do not see some linear progression there for the rate of failure. What you see is something that is broadly flat. The point is that that does not translate into a very strong correlation as a basis for imposing age based charges, which you would have to do anyway for every type as well as every age of meter. It is a very weak correlation at best.

More importantly, this estate management point is irrelevant to the foreclosure issue. Professor Grout did accept in cross-examination that this concern has nothing to do with

foreclosure. I have quoted his words there in para.83(a) where he said – he responded to me saying something like that:

> "It's a bit strong to say it tells us nothing but I agree it does not suggest that there's foreclosure."

We have the point that from the gas suppliers' point of view and the CMOs' point of view they should not care whether National Grid does, in fact, replace the younger or the older meters. So far as British Gas is concerned, Professor Grout did suppose that the gas supplier would want the more inaccurate meters to be replaced, but that was a question of fact on which he was not well placed to comment. As far as the CMOs are concerned, they are interested in getting their meter in and getting whatever there is there out. Indeed, if it is the case that the older meters, the ones more prone to fail, you would have thought they would prefer the younger ones to be replaced because then that increases the volume of the policy work going forward, which is later on going to be available to them. So that is all we say about normal competition.

You then pass to the extended demonstration in the Decision which is the age related counterfactual. This is the part with which Mr. Keyworth was concerned. I have said that National Grid's proposition is that there has to be some clear benchmark or line so that you know where you stand in advance before deciding what is illegitimate and what is legitimate.

Ofgem's case, we say, in para.85, and I hope it is not too mischievous, is that it is very important that you do not have that straight comparison. Instead, a counterfactual need only look at what would or might have happened. We say you do not approach things in that way if you are concerned that certain features of the conduct in question create a foreclosure problem. You take away those features and you look at a situation where you do have PRCs or exit charges which are constructed in a way which is truly comparable so that you can measure whether there is a foreclosure effect. You engage in a properly constructed exercise to do so.

THE CHAIRMAN: You do not put forward your own counterfactual, other than sale, which is not really a counterfactual, because you have not said what the price is that you assume. You say that they need a counterfactual against which to assess this. What would be a legitimate counterfactual as far as you are concerned?

MR. TURNER: We do it in two ways. The first way that we do it is to go through all of the arguments that I have just run through on normal competition, which means you do not even get to this need for a detailed quantitative comparison because of the normal

competition benchmark issue and the two ways that we have approached that. If you do go to a comparison with, let us say, an age based system of charges we have, with respect, addressed that, and that was Mr. Matthew's evidence. What he sought to do there was to say – it was criticised as being stylised examples – and I will come to this in detail in a moment, "if you want to carry out a proper comparison between this structure and this one to see whether one involves greater replacement opportunities than the other one you have to play fair, you have to assume certain things are held constant like the revenue neutrality". He was attempting to do that.

THE CHAIRMAN: It is not the age based nature of the counterfactual that you object to, it is the fact that it is not revenue neutral, is that right?

MR. TURNER: When you say that we "object to", we say that it is an unnecessary comparison to even get to, because as the Competition Appeal Tribunal and, indeed, as the competition authority, you should have stopped short, even from going there, there was no reason to engage in that sort of detailed measurement. If you decide for some reason that you want to try to compare this sort of structure with an age based PRC structure, which we do not say you have to do, then at least do it properly, and that is all that Mr. Matthew's reports were trying to achieve.

On that point, I mentioned at the outset para. 4.161 of the Decision, I am not going to go back to that now because I went into it in excruciating detail in the opening submissions, but you will remember that is the paragraph in which Ofgem said, in conjunction with various other bits and pieces in the Decision that this age related counterfactual was "a revenue neutral construction." We do not see it is capable of being understood in any other way. I said it in opening, it was not addressed by any of my learned friends in their response in opening, it was not addressed in cross-examination, it was not addressed in their closings, and that is where the position lies.

That takes us to para. 86, and 86 (a) and (b) where we say that if you are going to carry out a comparison with an age related counterfactual you do have to have certain conditions in place to make the comparison fair.

The first one is the revenue neutrality point. We say you do not need to think of it in terms of a guarantee under the one structure as opposed to the other, but as was canvassed in cross-examination by Mr. Pickford with Mr. Keyworth, there still needs to be some sort of likely expectation, which is the same in both cases because otherwise you can always design your contract in such a way that you have greater replacement incentives in the one than the other. The second condition, at 86(b), is from the gas suppliers' perspective as well

you must not create something which ends up being an entirely different animal from the one which they had bargained for, and that was the point about whether you can front load all of these charges into non-discretionary replacements, and say "You have to pay up front, through the nose for those, because that will then give you vast numbers of free meters if you choose to engage in that". It is a totally different kind of bargain.

Mr. Matthew explained those conditions in his evidence, we give the references in para. 87, and his evidence on those points was not challenged by Ofgem in cross-examination. Mr. Keyworth was challenged on those point and in our submission he did not give a good reason why these conditions were invalid in order to allow a proper comparison to be carried out.

Turning to paras. 88 and following, this is really recapping on the investigation of the question that was carried out in cross-examination with Mr. Keyworth; you have the point there. I would say in para. 88, the reference to transcript day 9 is Mr. Keyworth accepting the proposition that was put to him by reference to the table produced by Mr. Pickford, that under the age related counterfactual for the first three years you get the same number of non-discretionary meters in the pot but approximately 800,000 more free discretionary replacements, and that was the mathematics that we went through.

Paragraph 90 says that once you correct the analytical errors in Mr. Keyworth's and Ofgem's approach you see that the replacement incentives or, rather, the replacement costs that arise in these two situations are the same. That was Mr. Matthew's reports – we have given the references there, and the replacement cost estimates that Mr. Matthew refers to in these two situations were not the subject of cross-examination, they were not challenged.

Finally then, the resort to the CMO contract as a useful counterfactual, as a benchmark. You do have to have some solid basis for choosing a counterfactual, for how you set up your comparison. Ofgem's idea was that you can get this from the CMO contracts, because those contracts – the early replacement charging provisions were in a form that these contracts indicated to be sufficient to address the need to recover customer specific sunk costs (para. 92). That was a point made repeatedly in Mr. Keyworth's report, which was picked up in cross-examination and the point that was put to Mr. Keyworth was: how can a form be sufficient to enable you to recover your sunk costs? It is not the form alone that does it, it is what you put into the equation, it is the numbers, what was called the "calibration" that matters, and that is what Ofgem never attempted to do properly.

Ofgem put forward in their defence, as you saw at para. 212 the idea that one thing that could have been lawful would have been to estimate the overall sunk cost base and then

divide that up into a system of age related charges, and they would not have regarded that as abusive.

Mr. Keyworth accepted that they had not investigated what the sunk costs were. National Grid's written submissions, well before we arrived in this Tribunal did estimate the sunk costs of the installed metering stock and that was at no stage contested until the time of the defence to the notice of appeal. I have given the references to where we did it in the written representations at different stages there – at para. 94(b). My friend said in her response to my opening that they are perfectly entitled to do that, to raise in their defence a challenge to our estimate of sunk costs, because it is a point we have raised in the appeal. She referred to the *Napp* case. That is not what the *Napp* case says. The *Napp* case says that if you have a situation where an appellant comes before the Tribunal and for the first time in the Tribunal raises a new point it would be grossly unfair not to allow the competition authority not to meet that point in its defence, and I fully agree with that, but that is not the situation that we had here. We had a situation where we set out in detail what we said were the sunk costs, how you should arrive at the sunk cost, the relationship with the regulatory asset value, it is a major feature of our case and none of it is reflected in the Decision. All we did in the notice of appeal is to say that we rely on what we relied on before, and then it comes up in the defence. That is a different situation. I do not want to labour the point, but if, madam, you would pick up *Napp* in bundle A2, tab 38, you have the judgment of the Tribunal on this question, 8th August 2001, the relevant page is p.922, and it is three short paragraphs. At the top of p.922, para. 79 is where the Tribunal said that:

> "… our provisional conclusion is that there should be a presumption against permitting the Director to submit new evidence that could properly have been made available during the administrative procedure."

So that is different from what happened here. Paragraph 80:

> "On the other hand, there may well be cases where the Tribunal is persuaded not to apply the presumption we have indicated."

The Tribunal then refers to the importance of fair play and equality and so forth, and says at the end of para. 80 that an obvious example of where you would allow the Director, or the Competition Authority, to put in new evidence is where a party makes a new allegation, or produces a new expert's report which the director seeks to counter. That is not what happened in this case. It was all there beforehand. We did not raise a new point at the appeal stage. Paragraph 81 refers to the need for fairness in the appeal process itself; that the first occasion on which the Decision first receives full public judicial scrutiny is in this

Tribunal and that an appellant will often have submitted voluminous pleadings, witness statements and documents unconstrained by the evidence presented to the director.

So, it is talking there about what you put in at the appeal stage.

> "The director, at the administrative stage, may not always be able to foresee (although of course he should endeavour to do so) from what direction or in what strength an attack might come at the appeal stage. A situation whereby the appellant could always have a 'free run' before the Tribunal, but the director was always confined to the material used in the administrative procedure, could lead to a significant lack of balance and fairness to the appeal process".

I agree with that, and I say that with some feeling, having been on the other side of the fence. But, this is not that situation, and from where we are sitting now it is wrong that we should have developed something in such detail in the administrative procedure, and it should be met only in the defence to the Notice of Appeal for the first time.

So, what we say, to complete the circle on that point, is that if that was Ofgem's view, as it is said in the defence, at para. 212, they had the material, they had the information to create a more appropriately calibrated counterfactual. They could have done it with all the information they had.

The third point at para. 94(c) is the point about the twenty year cut-off. As well as the point that was majored on in the cross-examination relating to the UMS contract, I would draw attention to the fact that here we are talking about a contract about the Legacy meters, and the average age of these assets (which is in the Notice of Appeal, I think at para. 13) was, in 2005 at any rate, slightly more than twenty-five years. It makes it a very fair basis for saying that you could reasonably use twenty-five years as a basis for a system of age-related charges. If you do that, you end up with costs of replacement, even under the Ofgem approach, which are significantly greater and similar to those under the Legacy MSA.

THE CHAIRMAN: That is average calculated in what manner? Do you know? Is it that more of them were twenty-five years old than any other age? Or, add up the number of the ages of them and divide them by the number of meters?

MR. TURNER: Let me check. (After a pause): In fact, if I may open the Notice of Appeal and just look at para. 13 to check precisely what is said there -- Tab 2, p.174.

> "The average estimated asset life of National Grid's installed credit meters rose from nineteen and a half years in 2001 to twenty-five and a half years in 2005".

THE CHAIRMAN: That is something different. That is the estimated asset life of the installed DCMs.

MR. TURNER: Yes. That is what I meant to say. It is the average asset life of these ----

THE CHAIRMAN: That is different from the average age of the assets, is it not? That is how long you expect them to live.

MR. TURNER: Yes. I am grateful for the correction. That is the basis on which I meant to make the point - which is that if you expect them to live over twenty-five years it is reasonable to spread charges to the extent that you impose them over a similar period.

THE CHAIRMAN: That is important because that figure might be the same for the CMOs, although the average age of their meters of course is going to be a tiny amount.

MR. TURNER: Yes. (After a pause): The CMO contracts were negotiated between the CMOs and the gas suppliers on the basis that there is not - as far as we can tell - like-for-like replacement for at least the first twenty years. That was the CML letter to which you were taken by Mr. Pickford. In the CMO case, as opposed to the Legacy meter case, what they were trying to do was to build up a stock of new meters in place from which they would earn income. In the Legacy meter case what National Grid was doing with those installed assets was winding down a stock of existing installed meters. It was a different situation. Once you appreciate the differences in these situations you ask yourself how meaningful it is to cherry-pick bits and pieces and then use those to set up an age-related cocktail to compare against the Legacy MSA.

I say at the end of para. 97, where Mr. Keyworth was asked about the costs arising under the age-related counterfactual,

> "I guess I'm struggling because the question will obviously depend on precisely what you're assuming this age-related counterfactual to be. You know, the assumptions matter, I guess".

We agree with that. It is all about the assumptions.

So far as the BLRs (the below-line-rentals) tolerance band, or Take or Pay band are concerned, this leads, in our submission, to, at the very worst, the same costs as the age-related counterfactual when you are analysing it on a like-for-like basis. This was also explored with Mr. Keyworth. Once you take account of access rates and density issues, which means you might not be able, under an age-related approach to take out the nineteen year old meter (it might have to be the fifteen year old meter or the twelve year old meter), the costs that you incur -- If you take out a twelve year old meter you have got the PRC for the period from twelve years to the end of that contracted term. The costs could be much higher than under the BLR tolerance band. The point made in para. 98(c) is that the BLRs are, in fact, more flexible than the age-related counterfactual approach in one sense because

if you imagine, for example, a sudden reduction in the non-discretionary replacements, then you are better off - whereas if you have removed under the age-related basis your fifteen year old meter or your twelve year old meter you have paid your PRCs straight up-front and there is no question of getting back to a glidepath when you resume paying without the additional charge. That is on the age-related counterfactual.

Effects on competition and consumers I will take quite briskly. The first observation which I would make is that when you turn to that part of the Decision, what Ofgem does is no longer compare the features it objects to in the Legacy agreement against a counterfactual which has age-related charges, or whatever it thinks is a lawful way to proceed, and then measures which of those involves harmful effects on competition or consumers, or innovation. At this point in the Decision Ofgem switches to comparing the Legacy MSA (it simply says 'the Legacy MSAs) against a situation where you are back on the P&M terms. All of the analysis you will see is about comparing the Legacy MSAs against a situation where there are no long-term rental agreements at all.

So, one turns first to the interests of consumers. Everybody agrees that competition law is ultimately about preventing conduct from taking place which harms consumers. Counsel for Siemens and CML at one point suggested, we thought, the contrary on the basis of *British Airways*. But, in our submission, the correct position is that *British Airways* is authority for the proposition that you do not have to prove directly harm to consumers. You can take it as read that where you are protecting the competitive process strictly speaking the interests of consumers should thereby be looked after.

THE CHAIRMAN: Unless you are selling pharmaceuticals.

MR. TURNER: In the present case, however, Ofgem has not stopped by looking at the process of competition, which is part of its case. It has gone on to look at the effects on consumers, and it has sought to be quite specific and said, what are the effects on innovation? What are the effects on consumers? It has sought to draw concrete conclusions and to claim to have demonstrated in a concrete way that there is a problem directly.

Counsel for Siemens and CML suggested in his oral closing submissions yesterday that consumers must have been harmed because in the case of his client there was a reduction in the volumes, for whatever reason, that British Gas is prepared to make available to CML/Siemens. The price which CML/Siemens says that they are prepared to live with goes up, which means, he says, that consumers are going to end up suffering from this. The fallacy in that is that overall British Gas's metering provision costs were reduced as compared with the situation where you give the higher volume of work to CML by entering

into the MSAs. You have that from Mr. Avery's cross-examination. We have referred at para.103 to the point that he makes, which is in Camera. He made the point that on a net basis the company makes a cost saving in its metering provision.

THE CHAIRMAN: That is taking into account the effect of the Legacy MSA charges?

MR. TURNER: It is. It was put to him that consumers are going to end up suffering because what you are doing by not giving the competitors as much work is causing their prices to go up because they will say, "We have got less work, we are going to have to charge you higher prices". He said, "That is as may be, we bit that bullet and, in fact, we were quite conscious that we wanted to ensure that the competitors' business case remained viable, to leave them whole, but overall the best value that we get, the lowest cost for metering, comes if we enter into the Legacy MSA and harmonise what we take from you with that". That lower overall cost means that that is what is factored through and ultimately comes through to end consumers. That is the point that Mr. Avery made in response to the question when he was asked about it.

PROFESSOR STONEMAN: Did that not also involve a change in their plans so that they moved from somewhere around about a seven or a nine year replacement package through to the 18 year replacement package on the MSAs, so that you are not comparing like with like?

MR. TURNER: It is true to say, yes, that the gas suppliers, when they were deciding whether to enter into the Legacy deal – and this is where we come back to that table – said to themselves, "We have got these alternatives, we can either enter the Legacy MSA deal or we can do without it and we will stay on the P&M terms, thank you very much, and replace the installed meters using a competitor as fast as we can and taking the lower prices that we can get from the competitors over time". They then compare those two different situations and they arrive at the view that they are better off overall and over the full period by going down the Legacy MSA route, which by the way takes into account that the Legacy MSA route, itself, allows for a healthy degree of replacement of the installed meter stock by competitors. So they get the benefit there as well.

So my submission would be that they did do it right, the gas suppliers, they did compare like with like, and what they did was rationally decide what would lower their metering costs of provision over the relevant term.

I recall, sir, you asked Mr. Avery at one stage about whether he would sacrifice long term value for short term gain, and his answer was that it all depends on the discount rate that we used, but they took a view that they had factored in the future value of money, they had looked over the full term of the agreement and they had decided that taking this situation

overall and looking at all of the risks, including the risks of new technology, and so forth, this would give them the best value. It is that which then transfers down through retail competition between the gas suppliers to lower costs to the consumer. That is the way that the gas suppliers saw it. It is not simply part of our case.

The other point which we have at para.105 is the point which I mentioned at the outset, which might, as I say, seem trivial to you now, but which really is not, and Ofgem was right to be interested in it, that premature replacement, at least on a significant scale, is something to worry about. Mrs. Frerk referred to customers having to take the morning off work to have the meter changed. If you replicate that on a significant scale it is a big cost, a big economic cost, and Ofgem was right to be concerned about it.

So that is the consumer perspective. So far as competitors are concerned, I am going to take this very briefly. You have what we say in the note about it. Paragraph 106, and following sets out all of our specific points in relation to these issues. Our overall observation is that we say again that we do not see this as an issue that the Tribunal needs to resolve in order to decide this case, namely the precise extent to which reductions in volume for these specific operators were caused by the decision to enter into the Legacy MSA, even if that is the right comparison, whether the benchmark should have been as compared with entering into some different PRC type arrangement. For the reasons that I have now given several times that is our submission.

So I pass to innovation, para.111. We handed up a note on day 2 summarising our position. We say that Ofgem have not accepted that the risk of stranding of assets of the installed meters, if there is smart meter roll-out, and the disincentives for gas suppliers to engage in simply removing existing meters and putting in new smart ones arises just as much from meters that they put in under CMO contracts as under the Legacy MSAs, because all of these CMO contracts include a provision for what they call a technology replacement charge or factor. It lasts for a full 20 year period.

We have said at (b) that the inclusion of the glide path in the Legacy MSAs in fact renders it more conducive to a smart roll-out than the CMO contracts. We allow a certain predictable and large number of replacements to be carried out each year.

I do want to deal with the suggestion by Ofgem's counsel in closing submissions that the gas suppliers' concern was with the National Grid Legacy MSA contracts. I have referred in para.112 to the British Gas response to the BERR consultation on billing which was cited by counsel for Ofgem and British Gas say there, as you will see:

"Ironically, it is suppliers such as ourselves which moved away from the incumbent meter providers that face some of the highest stranding risk. Failure by the Government to deal equitably with stranding …"

which means giving compensation –

> "… will unfairly penalise those which have previously tried to make competition work."

So there is a pretty clear indication on their part that the problem arises because there is protection for installed assets for who ever is the meter provider and actually the ones such as themselves, who have gone for the competitive route find themselves, if anything, in a more difficult situation facing higher costs.

Counsel for Ofgem also took you to the BERR consultation to suggest that there was a link between government concerns over asset stranding and the Legacy contracts. Now, if that was meant to suggest that the Government was worried about the National Grid Legacy contracts we cannot accept that. The document refers to "legacy contracts", and that means the contracts that were in place for installed assets, whoever the meter provider is, and we say that it supports our point that the contracts of the CMOs have similar implications for smart metering.

The other point raised by counsel for Ofgem yesterday ----

THE CHAIRMAN: You say when it refers to "Legacy contract" it means any contract which includes a payment for taking the meter out and replacing it with a smart meter?

MR. TURNER: Yes, I do. There is no specific reference to National Grid there and in the context of these concerns, such as British Gas, and when you read the document as a whole that is what it must be referring to.

You then turn to the point which has now emerged that the real issue is not the implementation of smart meter roll out but the development of smart metering. The question that was raised yesterday about whether it was now being said that the Legacy MSAs have impeded the development of smart metering technology.

THE CHAIRMAN: That is the dynamic competition, dynamic efficiency?

MR. TURNER: It is an aspect of it. The idea is that it is not simply the implementation, the putting in of the smart meters which is blocked, but somehow the effects feed all the way back up to the development of smart meters. It is not something that is in the Decision. The Decision very explicitly is stated to be concerned with the impact on gas suppliers' replacement incentives, and we have referred paras. 4.123 and 4.126, in that short section which is concerned with innovation.

Secondly, quite apart from the fact that it has now cropped up but was not in the Decision, the reasoning behind it is flawed. Counsel suggested for Ofgem that you can ascertain this as a matter of objective fact for the Authority and for you and it is not simply a question of what the supplier thought at the time about the future of smart metering. There is no evidential basis which has been put forward on which you could make any such determination.

The third point at para. 117 is, as Professor Stoneman noted yesterday, there is not even an explanation as to how the development of smart gas meters in the UK feeds back into the global market for smart meter development, or how it can actually be separated from the market for smart electricity meters. It is not something which has arisen in this case, it is not appropriate to try and bring it in in this way in closing submissions.

Finally, I am not sure it is in **here**, it was said yesterday, on the question of whether there was an impact even in relation to the implementation of smart metering, because Ofgem's Decision found it was "entirely predictable" (their words) that the Legacy MSAs would impede the future of smart metering. They referred to a Mr. Robin Beasley's opinion at British Gas, and there was debate with Mr. Avery in the witness box about the significance of that comment. I wish to draw to the Tribunal's attention that it was not simply a disagreement between the views of two officials within British Gas, Mr. Avery's evidence was that Mr. Beasley's comment did not represent the view at British Gas. The reference was day 4, p.14, lines 28 to 30, and p.15 lines 1to 10.

At para. 118 there is a number of further points which I am not going to develop orally, but you will see there the errors made by Ofgem about how you would implement smart replacement. Certainly, the one thing I would address is there was a suggestion at one stage that meters, apart from National Grid's, have a facility for being upgraded very easily, and perhaps a suggestion that that is not true for the National Grid meters, but that is not the case. There was some evidence, you were taken to it in relation to Mrs. Frerk's examination: all meters are upgradeable, 53 per cent by means of what is called "pulse" technology, and 47 per cent by addition of an optical reader. We reject the suggestion which was made in the hearing that another kind of meter is more amenable to upgrade than the National Grid products.

THE CHAIRMAN: That is products currently being installed by National Grid when they install a meter?

MR. TURNER: I believe that the reference there, which came from the 2002 discussions, and I will check this, probably related even to meters which were in situ at the time. (After a

pause) I am told it related to the installed meters. The references there in para. 118 (b) which we can look at – I will not go to it now, it was one of the letters at WS2, tab 6, p.1246.

There was also the point made by Mr. Avery that the rate of roll out does not affect the business case for smart metering because he described how the benefit, and broadly the costs of doing this linear is on a per meter basis.

Then you come to "Dynamic benefits of competition". I only make two points about this. First, there is no need for argument on the essential point that the process of competition, effective competition should not be equated, certainly by this Tribunal with the idea that the more frenetic the activity you can encourage the better, because that will lead to dynamic competition, and that is what competition law is about. There is such a concept as too much, or artificial or uneconomic competition, to quote the words that were used by Mrs. Frerk, which you saw in the documents, and that is not the same as effective competition. We refer at 119(c) to the part of Dr. Williams' evidence where he was asked about dynamic benefits, where he pointed out that, let us say, there was some positive externality to be gained in the market place which could be seen as a social deficiency. He said that if there is some way in which the government or a regulator can correct for that, so much the better, but it goes too far to say that competition law requires a dominant firm – if there is a dominant firm, to adjust its behaviour so that it internalises, absorbs that externality and takes the hit. That, again, is not what competition law is about.

I turn to maintenance. Ofgem's case is that the bundling of maintenance, the failure to have separate charges for the maintenance and provision components of the rental has deprived CMOs of the opportunities to replace meters on maintenance visits, and that is said not to be a distinct abuse, because the effects are not sufficient in themselves to be material, but nonetheless, and in my submission inconsistently but they do materially exacerbate the effects of the charges if those are found to be foreclosing. On the one hand they are sufficient to add appreciably to those effects, but if they stood alone they would not be sufficient to be material.

Counsel for Ofgem in opening, and again yesterday, stressed the point that the Decision does include an allegation that if you deny a replacement opportunity on the maintenance visit to a CMO that could count against the glidepath allowance. She took you to a number of provisions to make that point good. I accept, having looked at it, that I was wrong about that. I do not say that the parts of s.2 of the Decision are relevant - those deal with the facts. Paragraph 4.181 is where you do find that allegation. The point, however, is that it rather is

buried in that paragraph which deals with the effects of the charging provision, whereas I had looked only at para. 4.182 which is concerned specifically with the maintenance. But, I accept that.

Nonetheless, Ofgem's case remains wholly unsustainable in the face of the evidence which the Tribunal has seen. A fundamental point is that the gas suppliers remain able at all times to direct any maintenance calls to their CMOs to attend and to swap out the meter - if they want to do that. Mr. Avery was cross-examined about that. "The CMO will not maintain the meter in that case - it has a replacement opportunity."

Now, in the case of the PPMs - which seems to be agreed account for the vast majority of the maintenance call-outs - suppliers prefer not to direct their CMOs to replace the meters, not because of the effects of this charge being bundled, but because National Grid's PPMs are cheaper because of the cross-subsidy applied for social reasons.

Counsel for Siemens and CML said that Mr. Avery raised that only orally - it was not in his witness statement. That was not true. It is in his witness statement. We have given the reference - para. 105 (para. 122(b) of the note) as well as Mr. James third statement and the reference to the cross-examinations.

In the case of credit meters there is what Mr. Avery described as 'close to zero' maintenance anyway. But, suppliers can equally direct maintenance calls such as they are to their CMOs who will then replace the meters in question. You will recall that when you come to the DCMs there are approximately 11,000 maintenance fault replacements a year - that is it - out of the opening population of 17.5 million. So, the maintenance bundling provisions do not impact on the replacement opportunities ----

THE CHAIRMAN: We did see some evidence in, I think, an answer that British Gas had given to a s.26 notice that said that when National Grid are called in to maintain a PPM, actually they replace it rather than maintain it, and that then counts as one of your free meters.

MR. TURNER: Yes. That is absolutely so. You will recall - if I have recollected the figures correctly - that you get about 600,000 maintenance call-outs a year for the pre-payment metres. In those cases about 15 percent (or 85,000) are cases where you have to replace the meter. For the rest we are not concerned about so far as this part of the case is concerned. So, yes, there are those 85,000 such cases. We do not dispute that that happens. What we do say is that the gas suppliers' decision not to make that replacement opportunity available to the CMO is entirely independent. It is because they are entirely free to choose whether to direct the fault call to their CMO, or not. It is their independent choice that they do not do so which reflects their view on what leaves them better off.

Paragraph 124 is an answer to counsel for CML/Siemens' question about why, if National Grid's meters are cheaper, British Gas chose to contract with the CMOs to do any prepayment work. We give the answer to that. The first is, as Mr. Avery himself said, because he was asked about it, "We wanted to give a source of activity for the CMOs to make their business viable; (2) because National Grid would not have agreed for British Gas to cherry-pick the credit meter replacement work, leaving the less profitable below-cost PPM replacement work alone with them" None of the parties addressed that evidence in closing submissions yesterday.

The new and replacement MSAs. Counsel for Ofgem has made no substantive submissions during this hearing in relation to the new and replacement MSAs. The Decision does not say that any feature of them is objectionable. They are held up as an example of normal competition. Suppliers were free to choose whether they signed either or both of the Legacy and new and replacement MSAs. It is true that those who have signed the Legacy MSAs have also chosen to sign the new and replacement deals, but that is not because there was any linkage made between them.

Now, in my copy of the note there are then square brackets because we have not plugged in the reference. Can I give you that? We set out that point ----

THE CHAIRMAN: I thought we had covered this in the opening when it was apparent from the operative paragraph of the Decision that refers to the MSAs -- I thought we had established that it was actually only the Legacy MSAs which were held to be abusive. But, I may have mis-remembered that.

MISS CARSS-FRISK: Madam, yes. It is the combination of the two in fact.

MR. TURNER: Yes. Counsel for Ofgem is right. Despite what is said in the operative part of the Decision the Decision finds that the new and replacement MSAs are also abusive. You will recall that I went to this right at the beginning of Day 1. In the defence they explain the position as saying that it would be artificial to divorce the one from the other. That is the basis on which it is said that these other ones are abusive.

THE CHAIRMAN: You were going to give us a reference.

MR. TURNER: Yes. It was PD1, Tab 8, pp.228 to 229 at paras. 206 and following. That simply establishes the point which we say cannot be gainsaid. It was an entirely separate deal. There was an entirely free choice on the gas suppliers about whether to sign these other deals.

THE CHAIRMAN: Is that a convenient moment for us to have a break?

MR. TURNER: It is, madam.

THE CHAIRMAN: How much more do you have, Mr. Turner?

MR. TURNER: Ten minutes.

MISS CARSS-FRISK: I am sorry. Madam, just before you rise, can I clarify? Of course, it is the combination of the Legacy MSA and new and replacement, and, in particular, how they work in relation to replacement on maintenance visits where the replacement then goes on the new and replacement contract.

THE CHAIRMAN: We will break for five minutes at that point.

(Short break)

THE CHAIRMAN: Yes, objective justification?

MR. TURNER: Madam, perhaps inevitably when there is a short break, one's clients say, "You really have to draw this to the Tribunal's attention", so there is a very short number of points which I am going to draw to your attention. The first is just to jog back to where we were a few minutes ago. There was concern that I had not been entirely clear about this situation where it is assumed that some PPMs would continue in situ being rented for longer than the seven year term of the glide path. It is said I ought to make absolutely clear to you, if I have not done so, that the PRCs were not calculated on that basis. The PRCs were calculated on compensation over the seven year period alone.

The second point arises from counsel for Ofgem's interjection just then about the role of the new and replacement agreement. A further point which arises from that is that if that is the reason why the new and replacement agreement is said to be abusive, the point would equally arise for the P&M agreement because in many cases you can imagine that somebody comes in and replaces the meter. They need not have signed up to the new and replacement agreement. If they then are on the P&M terms, does that mean that the fact that you are renting on those terms is abusive? It cannot do. It has to be something about the terms of the agreement with which you are concerned that gives rise to the abuse. You cannot say the mere fact that you come to an agreement in certain circumstances makes it abusive.

The remaining point relates to the inter-temporal arbitrage condition. It is not clear on this side to what extent that is felt to be material to the issues which the Tribunal has to decide or not. It is possible also that the Tribunal has not yet decided that. What we would say is this: if there is an issue which turns out to be material we would ask the Tribunal not to try to resolve that issue, if it is a technical issue of that kind, without first checking that it was put to Dr. Williams for him to be able to comment on it. If that were to be the case that would not be right, but I have no idea at the moment whether that situation arises.

PROFESSOR STONEMAN: But you could say it was put to Dr. Williams and he argued that it could not ever possibly arise because a new Legacy MSA would be put in place when the asset was 18 years old, you therefore ruled out the question as the question to which he wanted to give an answer.

MR. TURNER: I see. As I say, I am not quite sure how it will factor into your decision making, but I make that point.

The other point is that I referred earlier to the annex to the closing submissions which I handed up. I would ask you to look at that as well, because I am told that there are some further points there arising from Ofgem's closing submissions which may be relevant to that issue.

PROFESSOR STONEMAN: Which I have not yet read.

MR. TURNER: No, quite.

Objective justification: in so far as it is necessary to do so, National Grid's submission is that agreeing to enter the MSAs is objectively justified. It was a reasonable and proportionate method of further legitimate objectives of protecting the conditions of what is normal competition. Ofgem's counsel contended in her closing submissions, and we have set it out in para.128, that seeking to recover your sunk cost cannot amount to an objective justification for something that is otherwise abusive. In the Decision, if you open that up and look at para.4.131, you will see that the first sentence says:

> "The Authority does not (and never has) considered that is a *per se* abuse to enter into long term contracts for domestic gas meters that levy charges for the early replacement of meters."

As to that, I would only comment, well, you saw the first statement of objections, that is precisely what the situation was there. The material point for present purposes is the second sentence:

> "In particular, the Authority recognises that the use of early replacement charges ***may*** be necessary and proportionate to allow the recovery of ***customer specific sunk costs*** and that and that provision of domestic sized gas meters can result in some customer specific sunk costs."

It was accepted as the argument developed through the defence that you cannot work out what that is on an individual meter basis, and that, in fact, the sensible way to look at this, in our submission, is only on an overall basis when you are looking at the Legacy stock. Hence para.2.12 of the defence, Ofgem itself says you could have taken an estimate of the overall sunk costs and divided it up in that way. It is not consistent with that to deny now

that an exercise seeking to recover some but not all by a long chalk of your sunk costs cannot be an objective justification. That is all I desire to say about that.

Penalty, I will be very short. The argument on all of the technicalities of penalty is developed at length between the parties on the skeletons, including such factors as the starting point, the right percentage, and so forth. One point which I might mention now is that there is an issue about the turnover because at this stage Ofgem has taken into account UMS's turnover, together with National Grid's, for the purposes of the first stage of the penalty calculation.

In a sense, it is free to do that on one interpretation of the OFT Guidance, but in circumstances where it is holding up UMS as a CMO which has been harmed by the activity concerned, we say that that is an odd approach and an incorrect approach for it to take in principle.

Our main point is what was ignored from the calculation of penalty was the mitigating factor of the close dialogue that took place with the Ofgem officials, conducted in the course of negotiating the Legacy MSAs. We went through that in a lot of detail in the course of cross-examination of Mrs. Frerk. You had all the material there. The contemporaneous documents show that National Grid provided Ofgem with significant detailed information about the proposed arrangements, was responsive to the concerns of the Ofgem officials, did not hide material and made it aware, including through the charging statement that was subsequently provided to Mr. Howdon, of the features of the agreement, which are now under attack.

Ofgem's counsel has down played the process of engagement on the basis that National Grid's discussions were held in a regulatory context and not a competition law context. I understand and accept entirely that the company was not asking for competition law endorsement, it did not seek competition law guidance. That does not take anything away from the substance of the matter which you have seen on the papers that there was an extensive and detailed discussion about the issues arising from this proposed deal, including matters such as effects on competition, including the liability of such charges, including matters such as the structure involving a glidepath. In those circumstances Ofgem should not have seen as a potentially aggravating factor that we did not seek formal guidance, it should have seen as a mitigating factor the extent of the engagement that took place with Ofgem, and that should have been weighed in the balance – if you arrived there.

Madam chairman, that brings me only to my conclusion, subject to any questions the Tribunal may have.

THE CHAIRMAN: Just pause for a moment. (After a pause) Perhaps we will take questions now then?

PROFESSOR STONEMAN: Just one question. Do you view stranding costs that result from the opening up of competition differently from stranding costs that might result from innovation? The reason is that I did say some days back that "stranding cost" is a rather pejorative term. There is another term for stranding costs arising in the context of innovation, which is much nicer, and it is called "creative destruction", it is a very famous Schumpeterian term, and the idea of creative destruction is when new products are put on the market the producers of the existing products suffer. So, for example, at the moment what we know is that flat screen televisions are coming on to the market and they are much more popular now than t hey were, and the market for cathode ray tubes has disappeared completely. So now you can view this in two ways, this means that the people who produce cathode ray tubes, all their assets are now stranded, or you can just say: "This is the natural process of competition, their assets are valueless.

Now, the way that the MSA is structured is that it puts the risk of that technological stranding on to the gas suppliers as opposed to National Grid as the owner of the meter?

MR. TURNER: Yes.

THE CHAIRMAN: Do you think that is appropriate and is it any different from the stranding that you would get from opening up the competition? Do you see the two as equivalent or different?

MR. TURNER: I see them as equivalent because once you recognise that protecting your investment in this way is a normal thing to do, you then see when new technology arises, just in the same way as when cheaper products of the same kind come on the market, the customer takes into account the full economic cost of their replacement decision, whether to upgrade the new flat screen television or not, or whether to take the slightly cheaper version of the same thing or not. In either case it is appropriate for them to bear that cost. It is a risk which they have taken, as compared to a situation which previously was I think accepted on all sides, artificial in that the gas supplier has incentives to replace in this case, without facing the full costs of those decisions.

PROFESSOR STONEMAN: So the logical implication of that is that somehow society should compensate the manufacturers of cathode ray tubes because they can no longer sell cathode ray tubes, and therefore their assets are stranded?

MR. TURNER: I think one has to be careful because we are dealing here in this market not with a situation where you have a manufacturer of old televisions with cathode ray tubes sitting

in a factory which now can no longer be sold. What you are dealing with is a situation where you have the long lived meter assets in situ and where the provider in the circumstances of this market has made arrangements with the customer to ensure that some of their investment is more or less secured. That is an efficient arrangement. If the customer in those normal circumstances decides that they want to upgrade, it is a different situation because – yes, they do have to bear that cost – their upgrading from the existing item asset that they have to something better, something innovative, but different in my submission from the position of the factory owner who has lots of cathode ray tube televisions sitting there which will never come to market because people do not want them any more.

PROFESSOR STONEMAN: All right thank you.

THE CHAIRMAN: Just one point on the penalty. You also made a point, I think in the notice of appeal, about the directions were unclear in the operative part of the Decision, is that point maintained and, if so, to what does it go particularly?

MR. TURNER: The point is maintained. If I open up the operative part of the Decision, it comes to this, and it really takes us back in a loop to the remarks I was making right at the outset, para. 2 is that "National Grid put an end to the infringement identified in paragraph 1 above", and that is "take out of your agreements, or do not enforce these two features". Paragraph 3: "Orders that NG shall refrain from engaging in conduct having the same or equivalent exclusionary effect as the infringement identified in paragraph 1 above."

If you are in National Grid's position without a very clear idea of exactly by what lights you know whether you are engaging in this exclusionary conduct, it is extremely difficult to know whether you have satisfactorily complied with that, and it takes us back to the discussion about the indeterminacy of what exactly is the vice here. Is it too few meters that are available for free replacement? Is it the structure? What is it?

THE CHAIRMAN: Is there also a point here – of course there are many hurdles to overcome before we would get to this point if we ever got to it – that given that what this contemplates is National Grid having to go back to its contracting counterparties to renegotiate these contracts, whether there is anything that needs to be done for the new and replacement contracts, or whether changes to the Legacy MSA only would deal with the problem, I can see that that might be thought to be unclear.

MR. TURNER: I am going to confess at this stage that I do not have at the forefront of my mind all of the arguments that are included in the notice of appeal in relation to the direction ----

THE CHAIRMAN: We will have a look at that.

MR. TURNER: That may well be one of the arguments that we take and, if it is, it is pursued.

THE CHAIRMAN: Thank you. Yes, you had some concluding remarks that you wanted to make?

MR. TURNER: It is the final peroration and then we are done. When you step back from all of the detailed allegations that you have been battered with over the last ten days or so, National Grid's position is that this is a strange matter for Ofgem to have pursued because liberalisation of the gas metering business has been doubly successful. It immediately forced prices down on millions and millions, and millions of meters which were already installed. That was the expectation that you saw in the February 2003 management committee memorandum for Ofgem.

Secondly, you have seen - and this is where the table in the Notice of Appeal comes in - what we regard as a flourishing new competition in relation to new and replacement meters, which would have flourished even more other than the cloud which was placed over the industry and what was allowable as result of this investigation. All of that happened without the fear that Ofgem rightly perceived of ripping out of meters unnecessarily and the economic cost, waste, and customer disruption involved. We therefore pose the question rhetorically, "What is the problem that Ofgem now, supported by competitors who plainly and understandably perceive a competitive advantage, is seeking to solve by a retrospective attack on the agreed contractual framework which has delivered these benefits?"

In our submission the Decision is wrong from the beginning to the end. I have said at the outset that it presents an account of the industry complaint which led to the investigation, which was tailored and inaccurate. In the account of the facts it refers to - as we went through today - the issue of the settlement in the price control. I have taken you to the true interpretation of that. In the examination of dominance Ofgem did not refer to quite a large amount of relevant evidence which you have now seen in the course of the case, although it had received it concerning the bargaining process, and nor even referred to the issue about the outside option of the gas suppliers, although it was a big part of our case. On the issue of abuse Ofgem presented a case - where the structure of the arrangements was objectionable - which no industry party (and I emphasise this most of all) had ever complained about. Even now - even at the end of this hearing - no-one here is supporting Ofgem in saying, "That's the way it should have been done". It is an Ofgem-invented retrospective case -- to the analysis of foreclosure, a large part of the abuse section of the Decision, which merely involves presenting what amounts essentially to a stacked deck, but which is presented in 4.161 of the Decision as a revenue-neutral construction -- to the issue

of the penalty where Ofgem sweeps over the close dialogue which it held with National Grid during the negotiations. This Decision is unjust, it is wrong. There is a clear and overwhelming case for setting it aside. Those are National Grid's submissions.

THE CHAIRMAN: Thank you very much, Mr. Turner.

MISS CARSS-FRISK: Madam, I am certainly not going to attempt to respond to that, but a few very brief matters, if I may. First of all, can I hand up the note on the source of the price cap? (Same handed) The reference to where this can be found in the license itself is in WS3, Tab 15, and the exhibit to Mr. Smith's witness statement. That is where we have an extract from the licence that actually sets the price cap.

Then, four short points of factual correction, if I may, on what we have heard today.

Looking first at para. 2 of Grid's closing submissions, it refers to Mrs. Frerk as a co-author of the Decision. Of course, it is right for you to be aware that it is the Authority that takes the Decision of course, and Mrs. Frerk was a member of the case team, as is recorded on the front page of the Decision. But, it would not be right to describe her, as it were, as a 'taker' of the Decision.

Then, in relation to para. 15 of the Grid written note, it was suggested that our reference to practical logistics of buying and installing a large number of meters (para. 15(a)), and that this somehow supplemented the analysis in the Decision and was new -- That is not right. If you look at para. 3.68 of the Decision at p.56.

Then you may recall, in para. 79 of this document there was the reference to a footnote in Mr. Keyworth's evidence. That is actually referenced in Footnote 2 on p.31 of National Grid's document. They refer to Mr. Keyworth's Footnote 18. By way of clarification, what he had in mind was actually para. 22 of the relevant contract, which is CT1, Tab 4, p.793.

All I would ask you to note is that that paragraph does not apply to any gas supplier that has actually appointed CMOs. It only applies if you are a gas supplier that has not elected to do that.

Finally under this heading, National Grid referred to Clause 13(a) in the contract. All we say is that it is very important to also read Clause 13(b) to get the full picture.

The final note of correction concerns the dynamic benefits of competition and the topic of smart metering where, as I understood Mr. Turner, he was suggesting that that again was something new that had not been mentioned in the Decision. That is not correct. If you go to para. 4.123 on p.97, read with Footnote 331 on that page, one sees the dynamic benefits of competition very clearly referred to.

Madam, my very final point is about the importance of setting clear parameters for anything further by way of written note from National Grid. That was touched on yesterday. Now, our concern really about a level playing field is that it should not be open to National Grid now to come back in writing on any topic that they have already dealt with in their oral and written closing submissions that they have put in. In other words, what they may put in should be confined to topics that they have not had a chance, they would say, to cover. It should not be an opportunity for them to elaborate, or add, or make further and better sub-points on topics that they have already covered. We do feel strongly that this is a point of fairness because, obviously, we, and the interveners, only had the afternoon after court after the evidence had closed to do the best we could to counter all the points that we could anticipate, put them in writing, and deal with it orally as our best and final shot. National Grid have had considerably longer than that to perfect their written document and to deal with it orally. We are, as I say, really rather concerned that there should be very strict limits to what they can come back with in writing - for example, on the ownership analogy point.

THE CHAIRMAN: Can we just check whether you are actually envisaging putting anything in writing, Mr. Turner?

MR. TURNER: Only what I mentioned before, which, to be quite clear, is this: we did not have the opportunity to write all this earlier. We were up until five o'clock this morning in the doing of this. There are many, many references in the documents that we were given yesterday, which may have been prepared over the week-end for all I know, that we have not been able even to read in that time. I am not proposing to put in further submissions of any kind at all, but we need to be able to read things that I have not covered in order to say whether there is a problem with them. That is all it is, it is purely responsive.

MISS CARSS-FRISK: Madam, if one looks at the amount of time the parties have had, and I will not even go into how long we may all have been staying up or not, the reality is that, of course, Grid have had precisely the amount we have had, over the week-end or otherwise, and indeed more time, so our point does remain about that.

THE CHAIRMAN: I think we will leave it on this basis, that you have heard the concerns, Mr. Turner, that have been expressed, and you must be aware, therefore, that if you stray beyond what has been described in what Miss Carss-Frisk has said there are likely to be difficulties arising as to the appropriateness of our taking into account those submissions.

MR. TURNER: I fully understand that.

THE CHAIRMAN: I am not going to put any particular limit on what you can put in, and we will then consider what you have put in, and you will then be able to indicate if you take exception to anything.

MISS CARSS-FRISK: The concern of course then is that there may be a further round of submissions. We have a particular concern about anything further being put in on the famous ownership analogy where Grid already put in a note at the end of the evidence. They have heard what we have had to say and they have come back now both orally and in writing, and on that point in particular we have a real concern that they should not now be able to put in further material on that point.

There is also a timing issue. It does seem to us, again to ensure fairness and a level playing field, that they ought to put anything further in by close of play tomorrow.

MR. TURNER: Close of play tomorrow is actually going to be extremely difficult for us. If you were to say early next week, that is fine. We simply will not be able, for all sorts of reasons, to comply with that. What I would say in relation to my learned friend's strictures is that if you are going to interpret "topics" as meaning things like effects on competitors, the fact that I have mentioned that should not prevent us from being able to look at the bundle references and respond to things we have not read.

THE CHAIRMAN: Where we were up to last night was that you were going to respond to any references, any material that was included in the closing submissions that you had not had an opportunity to respond to in your submissions today. It seems to be at the moment entirely hypothetical as to what you are going to put in and whether there would be any legitimate objection to it. I think I would direct that you put in any submissions that you are going to put in by – would close of play on Tuesday be acceptable?

MR. TURNER: Yes, I am obliged, madam.

THE CHAIRMAN: We will then see ----

MISS CARSS-FRISK: At the risk of pushing my luck, I will do so, madam, it is not, with great respect, fair that National Grid should have several days in which to perfect what they want to say when we have done the best we can in a very short period with no time off at all, as it were, no gap.

THE CHAIRMAN: This is not a gladiatorial contest, Miss Carss-Frisk. Everyone has been working extremely hard on this case, and if Mr. Turner says that a very short timetable will put his team in particular difficulties then I am prepared to extend some latitude to him for those purposes. I think that is all I am prepared to do about this at the moment.

MISS CARSS-FRISK: That is obviously not a latitude we have sought and have not had, but so be it, madam.

THE CHAIRMAN: They are the appellants.

MR. TURNER: Nothing further from us.

THE CHAIRMAN: Thank you very much everybody. We appreciate that the burden that this kind of lengthy hearing places particularly not only on leading counsel but on all members of their teams, advocates as well as clients. We will, of course, now consider what we are going to do about this and read again the voluminous materials. We will be in touch in due course with our Decision.

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