MONCKTON CHAMBERS

National Grid plc v Gas and Electricity Markets Authority (Capital Meters Ltd and Siemens plc and anr intervening)

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The Competition Appeal Tribunal (the 'CAT') has recently decided National Grid's appeal against a finding by Ofgem that it had abused its position of dominance in the market for the provision of domestic gas meters.

The CAT upheld Ofgem's finding that the structure of certain early replacement provisions in agreements entered into between National Grid and gas suppliers, for the rental of domestic meters installed prior to 2004, have a foreclosure effect by dissuading gas suppliers from switching away from renting existing National Grid gas meters to allow competing meter operators to install and provide gas meters of their own.

However, the CAT also significantly reduced the fine payable by National Grid from £41.6 million to £30 million and struck down certain findings in the Decision, in particular in relation to contracts for rental of meters installed on or after 1 January 2004.

Facts and arguments on appeal

Pursuant to the Gas Act 1986, domestic customers are obliged to receive their supply of gas through a gas meter. Meter operators such as National Grid, typically buy meters from manufacturers and then provide them to gas suppliers in order that gas can then be supplied to a particular household. Meter Operators such as National Grid however typically retain ownership of the meter throughout its life and have traditionally sought to recover the costs of providing the meter (including the significant installation costs and any on-going maintenance costs) through the annual rental charges set for each meter (rather than through transaction charges for the initial installation).

In order to promote competition in the supply of gas meters (National Grid's predecessor, Transco, had a monopoly both in gas transportation and the supply of gas meters until the introduction of competition in 1998), a five year price cap for National Grid's metering rental charges was put in place in April 2002. In the same year, Ofgem launched an industry wide review ('the Review') leading to the adoption of the "supplier hub" principle, placing the responsibility on gas suppliers to appoint meter operators to provide and install meters at their customers' premises. National Grid entered into new contracts ('the P&M Contracts') giving suppliers the opportunity to replace National Grid's meters without notice without incurring any additional charges, National Grid being solely remunerated by monthly rental payments from the time of installation until the time of removal.

Given the significant fall in prices charged for gas meters by meter manufacturers between 1995 and 2000, National Grid was faced with the threat that new competing meter operators ('CMOs') would be able to undercut its rental rates and, by replacing National Grid's meters, would deprive it of the rental income stream from which it had expected, prior to the introduction of competition, to be able to recoup its costs of installation. Given Ofgem's refusal to adjust the price control, and with Ofgem's knowledge, National Grid entered into negotiations with each of the gas suppliers for a new contract covering the continued rental of meters that were already installed in customers' premises (the 'Legacy Meters').

As a result of these negotiations, National Grid entered into a Legacy meter service arrangement ('MSA') with British Gas that covered those existing installed meters owned by National Grid as at 1 January 2004. Under this agreement, British Gas would rent a declining minimum number of meters per year, for the duration of the commitment period (18 years for domestic credit meters and 7 years for prepayment meters) with early replacement charges payable by British Gas if the number of meters rented fell below that minimum. Equivalent contracts were also entered into with other gas suppliers. Separate contracts were entered into in relation to meters installed on or after 1 January 2004 ("New & Replacement MSAs").

Market definition

Ofgem found that the relevant product market was the market for the provision of installed domestic-sized gas meters, including the ancillary service of meter maintenance in Great Britain. The geographic market was not in dispute before the CAT. However, National Grid argued that there were separate markets for Legacy Meters and new or replacement meters. In particular, National Grid argued that due to the fact that unlike new or replacement meters, the costs of Legacy Meters were sunk, the economics of supply of the two meters were subject to real and objective differences. The CAT rejected this argument and upheld the finding of Ofgem on the basis that it was necessary to consider primarily demand-side substitutability. The product had been found by Ofgem to be the service of providing an installed gas meter and this had not been challenged. That service could be provided equally well from the customer's perspective by the operator owning the Legacy Meter and the operator who would provide the same service having installed a new meter.

Dominance

Ofgem had relied in its Decision on three elements to establish National Grid's dominance: namely, its high market share; the existence of barriers to entry and expansion; and the absence of sufficient countervailing buyer power ('CBP') to negate market power. Ofgem and the interveners relied on the fact that National Grid's large market share (98% in January 2002, falling to 89% in January 2007) was highly indicative and important. Ofgem also sought to rely on the disparity between National Grid's market share and those of its competitors. However, the CAT recognised that in the years immediately after a statutory monopoly had been lifted, there was a need to approach market share figures with caution. It was therefore necessary to treat market share as one indicator of market power but not raising any particular presumption of the existence of dominance.

The CAT however considered that there was "overwhelming" evidence of significant barriers to entry and expansion in the market. For example, the CMOs faced a number of logistical difficulties in starting up under the contracts that had been awarded to them and the requirement of economies of scale and density in the market also provided barriers to entry.

With regard to CBP, the CAT identified that the relevant question was whether the degree of CBP, in this case exercised by British Gas, being the biggest gas supplier in Great Britain, operated as a constraint on National Grid's ability to exert market power. National Grid relied upon negotiations with British Gas. The Tribunal accepted that the outcome of the negotiations was an agreement with which British Gas was, and still is, content; that National Grid had made important concessions and that National Grid did not succeed in setting rental and early replacement charge levels which resulted in it recovering its total sunk costs. However, the CAT considered that this fell short of demonstrating that British Gas had sufficient CBP to negate National Grid's market power to a significant extent. The CAT found that a key factor to consider was the options open to British Gas if the negotiations reached a stalemate. It was not open to British Gas to choose not to rent any meters from National Grid. There were a number of factors that placed National Grid in a different position to the CMOs. The fact that British Gas was content with the terms of the Legacy MSA was insufficient to establish that those terms were not anti-competitive. These factors included that British Gas was not a particularly price sensitive customer and that there would be disadvantages to the company if the National Grid rental prices were reduced below a certain level (in terms of the effect on the CMOs whose entry British Gas wished to support).

National Grid argued that the existence of sunk costs placed National Grid in a weak bargaining position if its aim was to recover as much of its sunk costs as possible. This argument was rejected by the CAT because British Gas had to have some arrangement with National Grid to pay for the Legacy Meters. While the existence of sunk costs may have influenced the nature of the contracts between CMOs and British Gas, the principal features of these contracts had already been set out in ITT documentation before the negotiations over the Legacy Meters started.

National Grid also argued that the regulated terms and conditions under the existing P&M Contract acted as a default position which was available to the gas suppliers when they were negotiating over the Legacy Meters. The CAT held that the existence of the price cap in this case did not negate the existence of market power. This case concerned an alleged exclusionary abuse and so Ofgem did not need to establish that National Grid could raise prices above the competitive level.

The CAT therefore concluded that National Grid was dominant in the relevant market at the time it negotiated and entered into the Legacy MSAs.

Abuse

Ofgem had accepted that in a market where long lived assets are installed in customers' premises and have a minimal re-use value if removed, it is legitimate for meter providers to protect themselves against the stranding of those sunk costs if the customer decides to replace that asset. National Grid argued that this recognition ruled out a finding that the Legacy MSA was abusive simply by reason of the early replacement charges for which it provided. The CAT rejected that submission. It considered that the relevant question in the case was whether the Legacy MSA went too far in protecting National Grid from the consequences of competition and whether the foreclosing effect was too severe to be justified by National Grid's desire to protect the revenue stream generated by its meters.

The CAT noted that the Legacy MSA operated in the same way as a contract obliging a customer to take a certain percentage of its requirements from the dominant undertaking. Further, the Legacy MSAs were not in its view a cost recovery arrangement but a revenue protection arrangement.

Ofgem had used counterfactuals to assess the effect of the Legacy MSA provisions by comparing the costs of carrying out a given replacement programme under the Legacy MSA with the cost of carrying out the same programme under one or more counterfactuals. The main counterfactual used by Ofgem was a contract in which the size of the early replacement charge was smaller for older meters than for younger (as was used in the CMO contracts and National Grid's arrangements for new or replacement meters).

National Grid challenged the use of this counterfactual on a number of grounds including that it was unrealistic because it would not have been feasible for the parties to enter into such a contract at the time the Legacy MSA was negotiated and that the counterfactual was neither revenue nor benefit neutral as against the Legacy MSA (ie both gas suppliers and National Grid would be financially worse off under the alternative contract structure). The CAT rejected this argument. It considered that this counterfactual was instructive. It was not necessary to establish that the parties would have entered into a contract along the lines posited in the age-related counterfactual merely that less restrictive alternatives existed to the Legacy MSA.

The CAT upheld the use of the age-related counterfactual which looked at what bargains had in fact been struck in the sector of the market where meter operators are subject to competitive pressures. It was relevant to look at what kinds of arrangements the CMOs regarded as giving them adequate revenue assurance such that they were prepared to enter the market, conclude contacts and carry out meter replacements. Having identified those terms, the CAT held the age-related counterfactual then assessed what would have happened if those kinds of provisions had been applied to the Legacy Meter stock.

The application of the age-related counterfactual in the CAT's view supported Ofgem's conclusions that an age-related approach would have provided CMOs with significantly greater opportunities to engage in meter replacement programmes whilst gas suppliers would face early replacement charges that would be substantially lower that those likely to be payable under the Legacy MSAs. The CAT concluded that it did not need to consider a further “no PRC” counterfactual.

The CAT held that the early replacement provisions of the Legacy MSA had a foreclosure effect in discouraging gas suppliers from moving more of their business to the CMOs and therefore were likely to delay the reduction of National Grid's market share. The CAT found that the actual effect of the Legacy MSAs was demonstrated by British Gas's actions taken to reduce the volume of business it provided to some of the CMOs, in order to avoid early replacement charges under the Legacy MSA. Capital Meters Ltd and Siemens plc introduced evidence and cross-examined on this issue as part of their intervention. Although the CAT accepted that National Grid had incurred sunk costs in providing the installed meter to the gas supplier without an installation charge, this could not justify putting in place charges which could maintain volumes of replacement at what the CAT regarded as little more that the level that applied when National Grid was a monopoly supplier. The

disproportionate nature of the early replacement charges was borne out in the CAT's view by the less restrictive provisions of the CMO contracts and National Grid's new or replacement MSA.

The CAT made no finding of abuse in relation to the New & Replacement MSAs; concluded that there was no foreclosure effect on one of the interveners and overturned the finding in Ofgem's decision that the MSAs had had a negative impact on the introduction of smart metering. It also held that the Direction which required that National Grid correct the abuse within 90 days was unreasonable and substituted a direction that this should be done as soon as practicable but with a report on progress to Ofgem within 90 days.

Penalty

National Grid argued before the CAT by way of mitigation that Ofgem had been involved all along in the discussions about the development of the Legacy MSA and had not indicated any serious concerns about its terms. The CAT held that Ofgem had been closely involved in and concerned about the roll out of the Review and that there were internal meetings at Ofgem where National Grid's proposals for its contracts with gas suppliers were discussed in detail. Following the first ever cross examination of a senior competition authority official about facts relevant to its decision, the CAT rejected the criticisms levelled at National Grid in Ofgem's decision that the company did not discuss the introductions of the early replacement charges openly and frankly with Ofgem. The CAT therefore considered that the history of the discussions justified a significant reduction in the fine of just over 25% to £30million.

Subject to any further appeal to the Court of Appeal, the outcome of the appeal is that National Grid will now have to renegotiate its Legacy MSAs with the gas suppliers.

The Appellant was represented by Jon Turner QC, Josh Holmes, Meredith Pickford and Laura Elizabeth John.

The intervener, Siemens plc, was represented by Christopher Vajda QC and Kassie Smith.

The intervener, Capital Meters Limited was represented by Christopher Vajda QC and Ben Rayment.

For more information on Christopher Vajda QC, Jon Turner QC, Kassie Smith, Ben Rayment, Josh Holmes, Meredith Pickford, Laura Elizabeth John and Fiona Banks please contact the Clerks on 020 7405 7211 or consult the 'Find a Barrister' Section at www.monckton.com.