Neutral citation [2006] CAT 7

IN THE COMPETITION APPEAL TRIBUNAL

Case No: 1042/2/4/04

Victoria House
Bloomsbury Place
London WC1A 2EB

31 March 2006

Before:

Sir Christopher Bellamy (President)
The Honourable Antony Lewis
Professor John Pickering

Sitting as a Tribunal in England and Wales

BETWEEN:

ALBION WATER LIMITED

Appellant

-v-

DIRECTOR GENERAL OF WATER SERVICES

Respondent

supported by

THAMES WATER UTILITIES LIMITED

Intervener

JUDGMENT
(BATH HOUSE)

Rhodri Thompson QC and John O'Flaherty appeared for the appellant

Jon Turner and Valentina Sloane (instructed by the Head of Legal Services, Ofwat) appeared for the respondent

Stephen Tupper (of Watson, Farley & Williams) appeared for the intervener

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I INTRODUCTION

1. Albion Water Limited ("Albion"), formerly a wholly-owned subsidiary of Enviro-Logic Limited ("Enviro-Logic") appeals against a decision taken by the Director General of Water Services (the "Director") on 11 May 2004 under section 47 of the Competition Act 1998 ("the 1998 Act") not to withdraw or vary a decision or decisions taken by the Director in a letter dated 8 March 2002 addressed to Enviro-Logic and/or a letter dated 26 March 2002 addressed to Thames Water Utilities Limited ("Thames") and published on 31 March 2003 (collectively referred to as "the Decision").

2. The Decision is to the effect that the conduct of Thames, in responding to certain requests made to it by Enviro-Logic and/or Albion from 2000 onwards for terms for the common carriage of water through Thames' supply network, did not amount to an abuse of a dominant position within the meaning of the Chapter II prohibition imposed by the 1998 Act.

3. Albion is a private company, now controlled by Dr Jeremy Bryan, its Managing Director, through its parent Waterlevel Limited, and is active in seeking competitive opportunities in the water industry. Thames is the statutory water undertaker for London and the Thames Valley, and has an extensive system for the supply of water to customers in that area. Thames apparently supplies drinking water to some 8 million people and sewerage services to some 16 million people. According to Thames' letter of 2 August 2005, the London area comprises a single Water Resource Zone.

4. It appears to be the case that the groundwater levels in the London area are rising. Paradoxically, it is also the case that there is at least potentially a shortage of water available for consumption, parts of the London area having what is known as a supply zone deficit. According to the summary of the Decision published on 31 March 2003, a "supply zone deficit" exists where there is a risk that the statutory water undertaker for the area in question would not be able to meet the totality of its customers' demands in a dry year. Although we were told during the hearing that a dry year occurs, on average, about one year in fourteen, it appears to be the case that some recent years have been dryer than average, giving rise to the prospect of supply shortages in the

London area. One factor which exacerbates supply shortages is leakage, which at the material time apparently accounted for about 23 per cent of water introduced into the Thames system.

5. Against that background, from the late 1990s Enviro-Logic, and its then wholly-owned subsidiary Albion, sought to develop a number of boreholes in the London area that might be used to supply water to customers. The extraction of groundwater through such boreholes for onward supply to customers could, according to Albion, both reduce the risks to London's infrastructure caused by rising groundwater levels, and help to address the supply zone deficits in the London area. In pursuit of this, Enviro-Logic has developed a borehole on the Hammersmith Hospital site to supply that customer, although operational difficulties have occurred and Thames remains the supplier of last resort. The development of such a borehole requires in particular pumping facilities and facilities for treating the water to the required standard.

6. By 2000, Enviro-Logic/Albion had identified two disused boreholes in East London, at Albion Yard (the site of a former brewery and not otherwise connected with Albion Water) and Bath House, which it was considering bringing back into operation in order to supply potential customers in the vicinity, such as the Royal London Hospital and Queen Mary and Westfield College. These boreholes were, according to Albion, among others identified in the London area which, in aggregate, could, says Albion, potentially supply some 14Ml[1] a day. The licensed abstraction for these two boreholes was apparently 131,760m³ per annum for Bath House and 274,500m³ for Albion Yard (equivalent to 1.1 Ml per day).

7. However, unlike the case at Hammersmith Hospital, where the borehole is on the customer's site, it was necessary for Enviro-Logic/Albion to secure terms from Thames for the transportation of the water from the Albion Yard and Bath House boreholes through the Thames system to the customers in question, i.e., "common carriage". On 31 May 2000, Enviro-Logic sought a common carriage access price from Thames to enable it to input supplies from Albion Yard and Bath House into the Thames system.

[1] The unit is a megalitre. One megalitre is 1,000 cubic metres or 1,000,000 litres.

8. Albion was, in 2000, a wholly-owned subsidiary of Enviro-Logic. The correspondence between Enviro-Logic and Thames indicates that it was intended Albion would be the company by which the boreholes would be operated. The abstraction licences for the boreholes, issued by the Environment Agency, were issued in the name of a third company, Metropolitan Water Limited, which was also at that time, and remains, a subsidiary of Enviro-Logic. The relevant correspondence before the Tribunal, whether on behalf of Albion or Enviro-Logic, involved the same individuals throughout, namely Dr Bryan and Mr Malcolm Jeffery.

9. In 2000, 50% of the share capital of Enviro-Logic was owned by Pennon Group plc ("Pennon") and 50% by individuals including Dr Bryan. Pennon is the holding company of South West Water Limited, the statutory water and sewerage undertaker for Devon, Cornwall and adjacent areas.

10. On 20 September 2000 Enviro-Logic complained to the Director that no access price had been supplied by Thames, despite its request of 31 May. On 24 October 2000 Thames provided an indicative access price of 27p/m^3.

11. On 1 November 2000 Enviro-Logic made a formal request to Thames for network access. Certain negotiations took place, but on 7 January 2001 Enviro-Logic complained formally to the Director that Thames' conduct was in breach of the Chapter II prohibition. As far as material for present purposes, the principal complaints were that Thames was: (i) proposing to charge an unfairly high common carriage charge; (ii) failing to propose fair terms to deal with balancing supply and demand; and (iii) guilty of an excessive delay in supplying a common carriage price.

12. In relation to (ii), the problem of balancing supply and demand arises because customers' demand fluctuates, for example at different times of day, at weekends, or at different times of year, or for other reasons. Thus, it could arise that, because of fluctuation in demand, at various times Albion's customers might not need all the water Albion put into the system ("over-supply") or, conversely, needed at certain peak periods more water than Albion could supply ("under-supply"). To address this, Thames was prepared to agree a "supply envelope" of maximum and minimum daily inputs, within which over- and under-supplies (known as "overs and unders") would be

balanced out over an agreed balancing period. However, in relation to supplies outside the agreed envelope, Thames considered that Albion should pay Thames for any under-supply, where Thames made up the deficit in Albion's supply of water to its customers, but that Albion could not expect payment from Thames in relation to over-supply, i.e. if Albion put into Thames' system water that was surplus to Albion's customers' needs.

13. Following lengthy correspondence and the intervention of the Director, on 11 January 2002 Thames offered Enviro-Logic a common carriage access price of 13.6p/m³, plus an annual supplementary charge. That price was substantially lower than the price of 27p/m³ originally offered. Albion does not now contend that the price of 13.6p/m³ plus an annual charge offered by Thames on 11 January 2002 is, or was, in breach of the Chapter II prohibition.

14. By letters of 8 March 2002 to Enviro-Logic and 26 March 2002 to Thames, the Director stated that he was closing his file on the complaint. In particular, these letters: (i) drew attention to the revised access price sent by Thames to Enviro-Logic on 11 January 2002; (ii) rejected Albion's complaint as regards the terms offered by Thames regarding over- and under- supply; and (iii) held that the delay by Thames in offering an access price between May and October 2000 was not sufficiently unreasonable to justify further work on the Director's part.

15. By a letter dated 6 August 2002, following the judgment of the Tribunal in *Bettercare v Director General of Fair Trading* [2002] CAT 6 as to what constituted an appealable decision, Albion requested the Director to withdraw or vary his decision to close the file under section 47 of the 1998 Act as regards the issue of over- and under- supply. The basis of that request was that Thames' intention to charge Albion for under-supply when its customers' demands were not met over the balancing period, but not to provide an equivalent credit for over-supply, had an adverse effect on Albion's ability to compete in the water market, and was contrary to the Chapter II prohibition.

16. The Director's decision to close the file contained in the letters of 8 and 26 March 2002 was published on 31 March 2003, following the Tribunal's further judgment on what constituted an appealable decision in *Freeserve.com v Director General of Telecommunications* [2002] CAT 8.

17. On 25 April 2003, Albion made a further request to the Director under section 47, requesting him to withdraw or vary the decision to close the file, on the basis that that decision was incorrect insofar as it found, according to Albion: (i) that Thames' original price of 27p/m³ was not an excessive price for the purposes of the Chapter II prohibition; and (ii) that the delay by Thames in not supplying an indicative price in the period from May to October 2000 did not constitute an infringement of the Chapter II prohibition.

18. On 6 May 2003 Pennon acquired 100% of the shares in Enviro-Logic, which subsequently changed its name to Peninsula Water Limited. At that stage Albion remained a wholly owned subsidiary of Peninsula Water, formerly Enviro-Logic.

19. On 19 February 2004, Waterlevel Limited, a new company set up by Dr Bryan, acquired Albion from Pennon. Ownership of Peninsula Water, formerly Enviro-Logic, remained with Pennon.

20. On 1 April 2004 the Director wrote to Peninsula Water stating that he was minded to reject the section 47 applications. Peninsula Water having made no comment, on 11 May 2004 the Director wrote again to Peninsula Water, rejecting the section 47 applications. Those letters were not sent to Albion. At that time the Director took the view, expressed in letters of 28 April 2004, 21 June 2004, and 7 July 2004 that Albion had no interest in the decision to reject the section 47 applications.

21. Fearing that it might be out of time if it did not appeal to the Tribunal within the two months required by Rule 8 of the Tribunal's Rules[2], on 12 July 2004 Albion brought this appeal to the Tribunal against the Director's rejection of the section 47 applications, without having had sight of the Director's letters of 1 April and 11 May 2004.

22. Before the Tribunal the Director subsequently conceded that Albion did have a sufficient interest to bring this appeal. However this appeal became effective only from 7 December 2004, when Albion served an amended notice of appeal, with the

[2] S.I. 2003/1372

Tribunal's permission, having by then obtained disclosure of the Director's letters to Peninsula Water of 1 April and 11 May 2004, and other relevant material.

23. In its amended notice of appeal Albion contends that the Director should have found three abuses of a dominant position by Thames, namely

> "(1) setting prices for common carriage at a level that made it impossible for a provider of water resources and treatment services that was both reasonably efficient and equally or more efficient than Thames Water, to compete with Thames Water in the supply of water within Thames Water's area of supply;
>
> (2) refusing to ascribe any value to the substantial additional water resources to be made available by Albion from the Bath House and Albion Yard boreholes; and
>
> (3) seeking to recover sums in respect of alleged balancing costs for surplus water that were wholly unproven."

24. According to Albion, the Director's failure to make such findings of abuse is due to errors of factual and legal analysis, and the failure to conduct a proper investigation. In addition Albion alleges that the Director was unduly influenced by a letter from Thames dated 11 February 2004, disclosed during the proceedings before the Tribunal and not previously put to Albion, stating that the latter had no real intention of developing the boreholes in question.

25. In its amended notice of appeal Albion asks that this matter be remitted to the Director to be further investigated under paragraph 3(2)(a) of Schedule 8 of the 1998 Act. Pursuant to paragraph 3(1) of that Schedule, the Tribunal must determine the appeal on the merits by reference to the grounds set out in the notice of appeal.

II THE STATUTORY FRAMEWORK

The 1998 Act

26. Pursuant to section 54, and paragraph 5 of Schedule 10 of the 1998 Act, amending section 31(3) of the Water Industry Act 1991 ("WIA91"), the Director has concurrent powers with the OFT to apply the provisions of the 1998 Act, notably in relation to commercial activities connected with the supply of water or securing a supply of

water[3]. The Decision under appeal was taken under section 18 of the 1998 Act imposing the Chapter II prohibition:

> (1) [A]ny conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.
>
> (2) Conduct may, in particular, constitute such an abuse if it consists in -
>
> (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
>
> (b) limiting production, markets or technical development to the prejudice of consumers;
>
> (c) applying dissimilar conditions to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage;
>
> (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.
>
> …"

27. Section 60 of the 1998 Act provides, in effect, that the principles of Community law are to be followed in applying the 1998 Act.

OFT 422

28. The Director, together with the OFT, has issued guidance on the manner in which his powers under the 1998 Act will be exercised within the area of his competence: see *The Application of the Competition Act 1998 in the water and sewerage sectors* (OFT 422). This guidance has not been amended or withdrawn.

29. It appears from paragraphs 4.16 to 4.20 of OFT 422 that the Director has regarded the use of his powers under the 1998 Act as an important means of allowing "common carriage to develop where there are genuine opportunities for improved services to customers" (paragraph 4.20):

[3] Since 1 May 2004 the Director's concurrent powers extend to the application of Articles 81 and 82 of the EC Treaty by virtue of the Competition Act 1998 and Other Enactments (Amendment) Regulations 2004 SI 2004/1261.

"4.16 The Director regards 'common carriage' as the shared use of assets by undertakings. In many circumstances it would be uneconomic for a competitor to duplicate the provision of large assets, such as a pipe network or treatment facility. Common carriage, therefore, has the potential to increase customer choice by facilitating the entry of competitors (whether existing undertakers or new entrants) into a local market.

4.17 There is no specific statutory framework for common carriage, but this does not prevent undertakings from agreeing to such arrangements, including the associated terms and conditions. In general, however, incumbent undertakers may have little incentive to offer access to their facilities to other suppliers. In some cases refusal to allow a competitor to access or share facilities may be objectively justifiable – where, for example, the competitor refused to give adequate assurances on water quality or refused to make a reasonable contribution to necessary reinforcement costs. In other cases the refusal may be without any objective justification. Under the Act, such a refusal by a dominant undertaking to grant access to facilities that would allow another undertaking to compete in a related market may be an abuse of a dominant position. Similarly, the imposition of unreasonable price or non-price terms for access could infringe the Chapter II prohibition.

4.18 The Water Industry Act 1991 provides an effective legal framework for the development of common carriage in a manner that safeguards customers' interests. Undertakers' approaches to the development of common carriage should not endanger the ability of the Director or of undertakers to fulfil their respective statutory duties. In this regard there are a number of issues that undertakers should address in any common carriage agreements. These include:

- the protection of water quality standards;
- establishing liability in the event of supply failures or quality incidents;
- responsibility for leakage and maintenance; and
- reasonable terms of access (including price).

4.19 None of these issues should, however, be used merely as a means of restricting competition via common carriage. The Director recognises that undertakers currently address many of these issues within their own operations.

4.20 The Director will, therefore, use his powers under the Act to deal with abusive conduct by dominant undertakings. This will allow common carriage to develop where there

> are genuine opportunities for improved services to customers."

Guidance letters

30. In a series of guidance letters to statutory undertakers issued under other statutory powers, the Director also referred to the development of common carriage within the framework of the 1998 Act: see MD 154 of 12 November 1999, MD 162 of 12 April 2000, MD 163 of 30 June 2000, MD 170 of 8 May 2001 and MD 177 of 27 September 2002. Among other things, these guidance documents required statutory undertakers to prepare access codes for meeting requests for common carriage. In MD 154 the Director stated:

> "The Competition Act 1998 (the Act) is an important milestone for the water and sewerage industries in England and Wales. From 1 March 2000, I will have stronger legal powers to remove barriers to competition. Within this new legal framework there are significant opportunities for market competition to develop. In particular, the Act opens up the scope for market competition to develop through shared networks, ie common carriage."

31. The guidance taken as a whole makes it clear that:

> "the Director General has a duty to facilitate effective competition. Consistent with this duty, and with the Competition Act 1998, companies will be expected to offer access to essential facilities on reasonable terms."
>
> (MD 163, paragraph 2(i))

32. In MD 163 the Director also states:

> "The Government's consultation paper on competition in the water industry[4] said that the properly managed development of effective competition is desirable. Common carriage is one route through which competition can develop further. It presents a challenge to existing companies, but it also creates opportunities for companies to develop and grow their businesses. Many companies have recognized this and I welcome their positive response…

[4] This refers to an earlier consultation paper, *Competition in the Water Industry in England and Wales*, April 2000

> Each company should charge entrants as it would charge itself and should be able to demonstrate this, both to entrants and the regulator, if asked to do so."

33. In March 2002, the Director issued a guidance document "Access Codes for Common Carriage" ("the Access Code"). As far as we know, no common carriage arrangements have in fact come into existence.

The WIA91

General

34. The following paragraphs describe the WIA91 as in force during the events giving rise to these proceedings. The amendments introduced by the Water Act 2003 ("WA03") are referred to later in this judgment.

35. Under the WIA91, the Director, through the Office of Water Services (Ofwat), is responsible for the economic regulation of the water and sewerage industries in England and Wales. Environmental regulation is carried out by other agencies, such as the Environment Agency, whose responsibilities include the licensing of water abstraction and the control of river water quality, and the Drinking Water Inspectorate, which regulates drinking water quality. The Secretary of State is responsible for the conditions of appointment of water and sewerage companies as statutory undertakers. The Secretary of State, DEFRA, and the Minister for the Environment in the Welsh Assembly Government, are responsible for the policy framework of the industry and have various reserve and other powers which are not relevant for our purposes.

The Director's duties

36. Section 2(1) of the WIA91 imposes general duties on the Secretary of State and the Director to carry out their respective functions under the WIA91. Sections 2(2) to (4) as in force at the material time provided:

> "(2) The Secretary of State or, as the case may be, the Director shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner that he considers is best calculated –

(a) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales; and

(b) without prejudice to the generality of paragraph (a) above, to secure that companies holding appointments under Chapter I of Part II of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of the functions of such undertakers.

(3) Subject to subsection (2) above, the Secretary of State or, as the case may be, the Director shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner that he considers is best calculated –

(a) to ensure that the interests of every person who is a customer or potential customer of a company which has been or may be appointed under Chapter I of Part II of this Act to be a relevant undertaker are protected as respects the fixing and recovery by that company of water and drainage charges and, in particular—

(i) that the interests of customers and potential customers in rural areas are so protected; and

(ii) that no undue preference is shown, and that there is no undue discrimination, in the fixing of those charges;

(b) to ensure that the interests of every such person are also protected as respects the other terms on which any services are provided by that company in the course of the carrying out of the functions of a relevant undertaker and as respects the quality of those services;

…

(d) to promote economy and efficiency on the part of any such company in the carrying out of the functions of a relevant undertaker; and

(e) to facilitate effective competition, with respect to such matters as he considers appropriate, between persons holding or seeking appointments under that Chapter."

37. However, by virtue of section 2(6A) of the WIA 91, inserted by Schedule 10, paragraph 4 of the 1998 Act, sub-sections (2) to (4) of section 2 of the WIA91 as in force at the

material time did not apply in relation to anything done by the Director in the exercise of his functions under the 1998 Act, unless it was a matter to which the OFT could have had regard when exercising those functions (section 2(6B)).

Appointment of statutory water undertakers

38. Pursuant to section 7 of the WIA91, the Secretary of State has a duty to ensure that, for every area of England and Wales, there is, at all times: (i) a company holding an appointment as a water undertaker; and (ii) a company (which may or may not be the same company) holding an appointment as a sewerage undertaker.

39. Following privatisation in 1989, the previously publicly owned water supply system operated by public water authorities was divided between a number of distinct companies, each of which was responsible for providing water services or water and sewerage services in a defined area of England and Wales. Each water undertaker, although privately owned, is now appointed by a written instrument setting out the conditions subject to which the appointment takes place. There are currently 24 incumbent water companies in England and Wales. Ten of these, including Thames, provide water and sewerage services, while 14 provide water only services.

40. A water undertaker must comply with the conditions set out in its instrument of appointment, and with the statutory duties and responsibilities imposed on undertakers. The conditions to be found in the instruments of appointment include conditions which limit increases in standard charges by reference to changes in RPI plus an adjustment factor ("K") set by the Director (Condition B); impose a charges scheme setting out standard tariffs for supplies of water for domestic purposes, which must be published (Condition D); and prevent undue discrimination and undue preference between classes of customer in setting charges (Condition E).

Inset appointments

41. Under section 7 of the WIA91 as amended, the Director has the power to replace an existing statutory water undertaker with another statutory water undertaker as the water and/or water and sewerage undertaker by an "inset appointment" for a specified

geographical area. Under section 7(5) of the WIA91, Albion holds an inset appointment on Deeside, limited to the premises of its customer Shotton Paper, as fully described in the Tribunal's interim judgment of 22 December 2005 in *Albion Water v Director General of Water Services (Dŵr Cymru/Shotton Paper)* [2005] CAT 40 ("the *Shotton* case"), which also concerns common carriage. In the present case it appears to have been assumed that Albion would in due course seek an inset appointment under section 7 of the WIA91 for the purposes of supplying the customers here in question, although the precise arrangements envisaged are not wholly clear to the Tribunal.

42. According to paragraph 1.2 of the Access Code, cited above, at the material time, there was no specific legal requirement for common carriage entrants to have an inset appointment. (This issue arose in Case 1050/2/4/05 *Aqua Resources v Director General of Water Services* which did not proceed to judgment, but involved a decision against the Director by the Ombudsman of 6 August 2004.)

The Water Act 2003

43. On 30 March 2001, the Government announced that it intended to increase the opportunities for competition in the provision of water services in England and Wales. In particular, it proposed to introduce a scheme whereby the Director would be able to license new entrants into the markets for production and retail activities. Following the Consultation Paper entitled *Extending Opportunities for Competition in the Water Industry in England and Wales*, published in July 2002, the WA03 received Royal Assent on 20 November 2003.

44. The WA03 amends the Director's duties under section 2 of the WIA91, notably by giving more prominence to the encouragement of competition between water companies. Most importantly, customers who consume at least 50Ml water per year will be able to purchase their water from water suppliers licensed under a new licensing regime as an alternative to their incumbent water undertaker.

The Director's amended general duties

45. The statutory duties imposed on the Director by section 2 of the WIA91 are amended by section 39 of the WA03. The new section 2 of the WIA91, as amended, replaces the previous version of section 2 set out above and includes the following provisions:

> "(2A)The Secretary of State or, as the case may be, the Authority[5] shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner which he or it considers is best calculated –
>
> (a) to further the consumer objective;
>
> (b) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;
>
> (c) to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
>
> (d) to secure that the activities authorised by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.
>
> (2B) The consumer objective mentioned in subsection (2A)(a) above is to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services."

The licensing provisions

46. The new licensing provisions under the WIA91 as amended by the WA03 came into force on 1 December 2005. Prospective water suppliers are able to apply for one of two types of licence. The first, a retail authorisation, enables the licensed supplier to purchase water at the boundary of the distribution network owned by the statutory water undertaker and a customer's premises, on a wholesale basis, in order to provide that customer with water on a retail basis: section 17A(2). This is referred to as a "retail licence": section 17A(4). The second type of licence, a "combined licence",

[5] The Water Services Regulation Authority will replace the Director from 1 April 2006. Under transitional arrangements the Director will carry out the functions of the Authority until that date. For convenience we refer to the Director throughout this judgment.

allows the licensee to input water into the statutory water undertaker's supply system and have its water conveyed through the distribution network owned by the statutory water undertaker, on a common carriage basis, in order to supply its end customer(s) with water: see section 17A(5) and (6) of the WIA 91. These provisions apply to customers with an annual demand of over 50Ml: section 17D(2).

Supply duties and charging provisions

47. In connection with these new licensing provisions, Section 56 and paragraph 3 of Schedule 4 to the WA03 insert a new Chapter 2A in Part 3 of the WIA91 which deals, among other things, with obligations and charges under the new licensing scheme. The relevant provisions are sections 66A to 66K.

48. These provisions:

- require a water undertaker to supply water by wholesale to a licensed water supplier for the purpose of enabling the latter to supply the premises of its customers in the area of that water undertaker in accordance with a retail authorisation (section 66A).
- require a water undertaker to permit a licensed water supplier who holds a combined licence to introduce water into the undertaker's supply system (or into the undertaker's treatment works), where water is to be supplied to retail customers of that licensed water supplier in that undertaker's area (Section 66B).
- require a water undertaker in one area (the secondary water undertaker) to provide a licensed water supplier, who holds a combined licence, with a supply of water for the purpose of supplying water to retail customers in the area of another water undertaker (the primary water undertaker) using the primary water undertaker's supply system (section 66C).

49. Section 66D(1) and (2) provide that the terms and conditions on which supplies are made available by water undertakers to licensed water suppliers in accordance with

Sections 66A to 66C are to be agreed or, in default, determined by the Director[6]. Section 66D provides:

> "(3) The charges payable by a licensed water supplier to a water undertaker under an agreement under paragraph (a)(i) or (ii) of subsection (2) above or a determination under paragraph (b) of that subsection shall be fixed in accordance with the costs principle set out in section 66E below."

50. Guidance as to the terms and conditions of supply, and as to how the relevant charges are to be fixed, is to be issued by the Director: sub-sections 66D(4) to (6). Such guidance is required to be followed: section 66D(7) and (8).

51. Section 66D(9) provides that no direction may be issued under section 32 (directions as to agreements) or 35(2) (interim measures directions) of the 1998 Act by either the OFT or the Director in respect of an agreement made under section 66D of the WA03. However, the effect of section 66D(10) is that the OFT or the Director may issue interim measures directions under section 35(1)(b) of the 1998 Act in respect of conduct connected with agreements reached under section 66D of the WA03 if they have a reasonable suspicion that the Chapter II prohibition has been infringed.

52. Nothing in section 66D or elsewhere in the WA03 appears to preclude the OFT or the Director from enforcing the Chapter II prohibition imposed by section 18 of the 1998 Act[7], including issuing directions under section 33 of the 1998 Act to bring to an end conduct which infringes the Chapter II prohibition.

53. Sections 2(6A) WIA91 as amended by the WA03 continues to provide that the Director's functions under the 1998 Act are not subject to his duties under section 2 of the WIA91 save as provided by section 2(6B): WA03, section 39(7). Those duties are also subject to any duty or requirement arising under another enactment, or by virtue of a Community obligation: section 2(7) of the WIA91 as amended.

54. Section 66E of the WA03 sets out "the Costs Principle" to be applied under section 66D(3).

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[6] From 1 April 2006, by the Authority which replaces the Director.
[7] Or since 1 May 2004, Article 82 of the EC Treaty, if applicable, pursuant to Article 3 of Regulation (EC) No. 1/2003.

55. None of the above provisions of the WA03 were in force at the time the Decision under appeal was taken, albeit that the WA03 received the Royal Assent in November 2003, i.e. between the Director's initial decisions of 8 and 24 March 2002 and his refusal of 11 May 2004 to reconsider those decisions.

56. As we understand it, to carry out the proposed arrangements after 1 December 2005, Albion would need a combined licence under section 17A(5) of the WIA91, which would entitle it to introduce water into Thames' system under section 66B for the purposes of supplying the customers, the charges to be determined under section 66D(3) according to the Costs Principle in section 66E.

III THE BOREHOLES

57. Albion's proposal was to extract water from the disused boreholes at Albion Yard and Bath House (both in East London) in order to supply that water to customers in the vicinity. According to Albion, this proposal was part of its larger plan to exploit a number of similar boreholes in the London region.

58. There was some confusion in Albion's submissions as to the precise current status of the two boreholes here in question. In its amended notice of appeal, Albion submitted that it had "acquired water resources" at those sites. In its reply, it clarified that leases of each site have been retained by Pennon. Albion's suggestion is that if the legal and other hurdles could be overcome, there is no reason to suppose that Pennon would be unwilling to transfer those leases to Albion, or that Albion could not be involved in the development of the boreholes in some other way.

59. In both cases, test pumping had been carried out by July 2000 and abstraction licences had been applied for and/or obtained from the Environment Agency.

60. Albion considered that using the boreholes to supply water to local customers would have the dual advantage of helping to address London's problem with rising groundwater and helping to address water shortages in the area.

61. In support of its arguments concerning the benefits of extracting water, Albion referred us to the work of the General Aquifer Research, Development and Investigation Team

("GARDIT"), which in 1997 was chaired by a representative of Thames. Albion explained that one option that was being considered in November 1997 in relation to London's rising ground water levels was that public funds should be used to extract water from the London water table and pump it to waste. In addition, Albion referred to Ofwat's 2001-2002 report on tariff structure and charges, which suggested that the Director had concerns about the security of water supply in London, ranking Thames 23rd out of 24 water companies on that criterion. Albion also referred us to Thames' plans to provide additional water resources for London, including the building of a £200 million desalination plant in East London.

62. The potential benefits of using the boreholes to supply water described by Albion were in issue between Albion and the Director: see further below.

63. An agreed statement of facts was prepared, at the Tribunal's request, setting out how boreholes such as those at Bath House and Albion Yard may be used for the supply of water. We summarise briefly that agreed statement of facts.

64. A borehole is a hole drilled into the ground to penetrate an aquifer in order to measure, or abstract, the water contained in the aquifer. An aquifer is a rock formation from which groundwater can be abstracted. Boreholes for ground water abstraction are usually between 150 mm and 1000 mm in diameter and are partially lined with steel or plastic tubing to provide structural support. Electronically driven pumps are used to raise the groundwater to the surface. Most modern borehole pumps comprise an electric motor and a suction component and are installed in the borehole at the appropriate depth below the water table.

65. As water is pumped out of the borehole, the water level is lowered, allowing more water from the aquifer to enter the borehole. The water level will remain stable when the amount of water entering the borehole equals the amount pumped out. If the pumping rate is increased, the water level in the borehole will fall. The Environment Agency is responsible for controlling the volume of water taken from ground water sources and the volume at which it is taken. It will not issue a license for abstraction that will adversely impact on the environment or on abstraction licences already held.

66. Generally, pumping systems in boreholes are designed to stop automatically if water falls to a predetermined level and to restart automatically when the water rises to a predetermined level. This protects the pump from overheating and seizure.

67. Once water is abstracted from a borehole, a range of treatment processes are then applied to the groundwater before it can be supplied to customers. The degree of treatment will depend on the quality of the water and the purpose for which the water is intended. In the case of water intended for introduction into public supply systems, any new water introduced into the system must not compromise the undertaker's ability to comply with the relevant water regulations. There are set limits, called prescribed concentration values or "PCVs", for a wide range of compounds contained in water. Water in which any of the PCVs are exceeded, however infrequently, must be treated with an appropriate treatment process. In addition, water undertakers are likely to have a number of internal quality standards that place further limits on the concentration of some substances according to local circumstances, for example, to avoid aesthetic problems which might result from mixing water from different sources, in terms of colour or taste.

68. All water must also be disinfected prior to supply. At Thames' groundwater treatment works disinfection of water takes place by chlorination. This is the principal barrier to pathogenic organisms. Chlorine is added to the water in such a way as to maintain protection after the water has left the treatment plant and travels through the distribution system.

69. At Thames' groundwater treatment works, all key equipment such as chlorine dosing pumps and storage tanks is duplicated. In the case of monitoring equipment, two standby units are used to prevent failure of the process. Information collected by the monitoring equipment is relayed to one of two continuously manned Thames control centres. In the event of a major problem, a water treatment works will shut down automatically, without the intervention of an operator.

70. Typically, output from a borehole treatment plant will be carried through an appropriately sized pipe to a point where it can be connected to an undertaker's distribution system. The undertaker is responsible for making the connection between

the borehole output pipework and its own water supply network. It must also ensure that any such connecting pipework meets certain standards of construction. A connection directly into a distribution main would be achieved by connecting through a suitable pressure reducing, or pressure control, valve. These pressure control valves can be operated automatically by hydraulic and electronic means to regulate the pressure and flow in distribution mains.

71. The traditional means of operating a borehole was by means of fixed speed pumps which typically worked at a constant, steady rate. The result was that the volume of water flowing from the borehole into the network was fixed and could only be controlled by manual variation of the pump speed. For Thames, it is common to shut some sources according to demand, and/or to comply with conditions in the abstraction licences granted by the Environment Agency as regards maximum extraction volumes. Service reservoirs within the distribution system are used to balance supply shortfalls and surpluses that result from fixed borehole output: during periods when output exceeds demand, the excess water produced can be stored for later use in periods when demand outstrips supply.

72. More recently, variable speed pumps have been fitted both at the base of larger boreholes, controlling the level of groundwater pumped from the aquifer and downstream of the treatment works to control the flow of treated water from the borehole into the network. These variable speed pumps can be operated from a central control centre which monitors real time information on customer demand across the water supply network and balances all available sources of water, including boreholes, to meet this demand in the most efficient manner possible. The control centre has the ability to control flows from the borehole by remotely activating pumps and valves. This means that it is possible for the actual volume of water flowing from the borehole into the water supply network to be varied, even from hour to hour.

IV THE REQUEST FOR AN ACCESS PRICE

The correspondence in 2000

73. Albion considered that it was not feasible to use the boreholes at Albion Yard and Bath House to supply water direct to its intended customers since laying a new pipe to the premises concerned would be difficult or impossible, e.g. because of the presence of the London Underground line under Mile End Road in East London. Albion therefore entered into discussions with Thames concerning the possible use of the Thames network to deliver water from the boreholes to its customers.

74. The Director had written to the statutory water companies on 12 November 1999 stating that:

> "Each company should be ready by 1 March 2000 to respond positively and substantively to enquiries and requests to share the use of its infrastructure. It should have ready a statement of principles that would govern this shared use. Any company that is not in this position may be subject to complaints from potential competitors."

75. Mr Jeffery of Enviro-Logic requested an indicative network access price from Thames at a meeting which took place on 31 May 2000. An e-mail of 20 June 2000 from Mr Jeffery to Ms Newman at Thames asked whether an indicative price was yet available.

76. Ms Newman responded in an e-mail dated 22 June 2000:

> "As I explained at our meeting, we have calculated a network access charge based on the principle of average cost recovery and Thames have taken into account the desire from the government not to de-average prices.
>
> However, there is a range of views across the industry which may shift as a result of the consultation by Ofwat over the summer.
>
> I cannot, therefore, offer you assistance in this matter at present, but please be assured that I will as soon as I am able to do so."

77. Further communications took place during the period July to September 2000. Enviro-Logic made repeated requests for a network access price and for guidance on how Thames would intend to calculate such a price. A number of other potential projects

were also referred to in these communications, including, in particular, a greenfield development at Beddington.

78. E-mails from Thames to Mr Jeffery of Enviro-Logic dated 18 September and 20 September 2000 indicate that Thames had decided, by that point, that an indicative access price would be provided only on receipt of a formal application for access from Enviro-Logic. On 19 September 2000 Enviro-Logic and Thames signed a confidentiality agreement in respect of their negotiations.

79. Enviro-Logic complained to the Director on 20 September 2000 that Thames was abusing its dominant position by refusing to provide an indicative access price.

80. In response to this complaint, the Director sent a letter to Thames on 5 October 2000:

> "We understand the need for incumbent companies to require information about an individual case before being able to arrive at a definitive access price. However, we are disappointed that Thames does not feel able to provide a definitive price or range of prices. Access prices should be consistent with prices charged to other customers. In this respect, much of the information needed to calculate an indicative price is already available to you. Other network companies (e.g. Transco) publish a scheme of indicative charges for access.
>
> You should be able to provide an estimate by using data already available. For example, table 30 of the Ofwat report on Tariff structure and charges shows long run marginal cost estimates for bulk transport and local distribution and this could provide a basis for an indicative price. We expect that EL and Thames could reach a working consensus on other parameters, such as the likely points of connection. The indicative price can then be refined as the various parameters are confirmed.
>
> We would not expect an indicative price to be set at a prohibitively high level to deter a potential applicant."

81. Thames responded by sending a letter to Enviro-Logic dated 24 October 2000 in the following terms:

> "The average cost of using our network is 27p/m^3.
>
> This includes components of operating costs, capital maintenance charges and return on capital employed for the assets employed. The costs are averaged for the network as a whole and do not include any distance-related charges. This is

consistent with the charge made to our existing customers and does not discriminate against any users of the network.

This is only one aspect of the charge for use of the network. At this moment we are unable to give you firm prices for the following due to the fact that they are application specific and we have still not received an application from you:

- Supplier of last resort – this is a two fold charge based on a risk assessment of the likelihood of failure of supply. I understand from your discussions with my staff that you are interested in a relatively small volume such that this element of the charge would be a small proportion of your overall costs.
- Physical connection fees – this will be provided as an estimate once your connection point is agreed.
- Amendments to the network required as a direct result of your application."

82. On the same day that this letter was received, 27 October 2000, two letters were sent from Enviro-Logic to Thames. The first, addressed to the Company Secretary of Thames, enclosed a formal application for access from Enviro-Logic. The application included basic details of Enviro Logic's plans for the two boreholes, a copy of an abstraction licence for Bath House and confirmation that the granting of the abstraction licence for Albion Yard was expected following successful test pumping, for 280,000 m^3 per annum. It also identified a number of potential customers which Enviro-Logic proposed to serve: (i) Queen Mary and Westfield College, which had three sites in the vicinity of Mile End Road; (ii) a company called Bishopsgate Space Management Limited in Bishopsgate Goods Yard; and (iii) the Royal London Hospital in Whitechapel Road. Enviro-Logic also confirmed that it did not propose to construct back-up facilities or storage facilities of its own. It requested supplier of last resort facilities be provided by Thames.

83. The second letter of 27 October 2000 was sent from Mr Jeffery to Mr Chant, the Commercial Director at Thames (copied to the Director). Mr Jeffery stated that Enviro-Logic was prepared to progress the application, even though Thames had provided "less information than sought". He also referred to Ofwat's guidance in MD 163 to the effect that a proposed access charge should be derived in a "robust and transparent" way and made clear that he expected further details regarding the calculation of the

charge to be provided and to be able to explore the derivation of the Thames access charge during subsequent negotiations.

84. On 2 November 2000 Thames replied to Enviro-Logic indicating that it was concerned that its staff had already spent considerable time trying to accommodate Enviro-Logic's needs and complaining that Enviro-Logic had repeatedly failed to provide any real substance or clarity to its proposals.

85. However a further letter from Thames to Enviro-Logic, dated 6 November 2000 did provide more details of the basis of the proposed network access charge of 27p/m^3.

86. On 8 November 2000, Mr Jeffery of Enviro-Logic responded to the letters from Thames dated 2 November and 6 November 2000. He denied that the delay could in any way be attributable to Enviro-Logic's own conduct, and requested a meeting to discuss his concerns about some elements of Thames' calculation of the access price. Following further correspondence, it appears that at this stage, on an average accounting cost basis, the difference between the parties was of the order of 6p/m^3.

87. A meeting took place on 30 November 2000 at which Thames confirmed that it did not intend to offer a discount to Enviro-Logic for serving large users. In a letter of 21 December 2000, Thames stated that large user discounts were irrelevant to the access price and that Thames would set a single charge, irrespective of distance travelled or customers served. In a letter to Thames of 5 January 2001 Enviro-Logic commented that in refusing to consider this issue further, Thames was refusing to "charge [Albion] as they charge themselves", and was, in effect, refusing to give credit for the lower levels of leakage from the infrastructure used to supply large users, and was taking a position which was "perverse".

88. On the issues relating to supply and demand, Thames' letter of 21 December 2000 states:

> "2.9 **Balancing**
>
> Chapter 5 para 12 of the Network Access Code states:
> 'the applicant shall have access to or be licensed for abstraction of water for potable supply sufficient to meet anticipated demand of the applicant's customer for

> average and peak periods, including growth, and to meet hydrological conditions which may be expected to occur statistically once in 10 years'. TW proposed a once a month routine of balancing water input, from AWL sources, into the TW network and consumption by AWL customers.
>
> …
>
> 3.2 **Partial supply**
>
> AWL proposed supplying only a part of the demand of some of their potential customers and suggested that TW would continuously meet the remainder of the demand. TW highlighted the complex legal and practical issues that would be raised by the sharing of customers. TW would not be prepared to accept a common carriage application on this basis and expected AWL to supply the quantity of water to match the peak demand of the AWL customers.
>
> 3.8 **Demand and supply match**
>
> AWL requested clarification for the situation where AWL customers do not consume their expected demand, but AWL put the full amount into the network. TW suggest that the total consumption of the AWL customers is the responsibility of AWL. If the customers do not use the volume of water expected by AWL, then that is a matter between AWL and its customers. TW would accommodate the daily operational variation in demand and these would be accounted in the manner indicated in paragraph 2.9 above."

89. In response, Enviro-Logic indicated, in its letter to Thames dated 5 January 2001, that

> "a situation where AWL pay for any short term shortfall, but lose the benefit of any overprovision is unfair, and is likely to constitute an abuse of a dominant market position".

The complaint of 7 January 2001

90. Following this correspondence, a further formal complaint under the 1998 Act was addressed by Enviro-Logic to the Director on 7 January 2001, signed by Mr Jeffery. In that complaint Enviro-Logic alleged that Thames Water: (i) had imposed an unfair and excessive access charge, not supported by a fair and reasonable allocation of costs and not complying with the Director's guidance, notably as to transparency; (ii) was "applying dissimilar trading conditions" in refusing to give Enviro-Logic the benefit of lower cost allocations for large user tariffs; and (iii) was imposing unfair trading

conditions in proposing to charge Enviro-Logic in case of under-supply while giving no corresponding benefit in case of over-supply. Enviro-Logic also complained that there was a general attitude amongst incumbent companies in the water industry to take action only at the last possible moment, thereby delaying effective competition and, furthermore, to make sure that the costs of establishing the ground rules for competition fell on new entrants.

91. The Director responded to Albion on 16 January 2001 indicating that the complaint was being considered under the 1998 Act, and that the Director would respond by 20 February 2001 with an indication of whether any further action would be taken. The Director also indicated that Enviro-Logic should submit any background documents in support of its complaint, which it did on 1 February 2001.

92. On 19 February 2001 the Director informed Enviro-Logic that it considered that Enviro-Logic's complaint justified further work.

93. In the meantime, correspondence between Enviro-Logic and Thames had continued, with Enviro-Logic elaborating on its grievances concerning the access charge, notably the lack of a large user discount, and the lack of credit for over-supply of water. On the issue of the supply/demand balance Thames stated in a letter dated 12 January 2001:

> "3.8 **Demand and supply match**
>
> TW expect AWL to supply water into the network to match the demand profile of its customers including an allowance for leakage. Since our meeting, we have given this further consideration. TW would not reimburse AWL for water supplied into the network that is not consumed by AWL customers. TW would accommodate the daily operational variation in demand, within a small percentage that we will need to agree between us. Small variations from the demand, both excess and shortfall would be calculated once a month and the balance carried forward to the next month. Should the balance fall out of the agreed percentage the following will apply:
>
> (a) Excess supply – AWL will be required to reduce the quantity of water into the network.
>
> (b) Shortfall of water – AWL will be required to reimburse TW."

94. In its reply of 24 January 2001 Enviro-Logic said on the supply/demand balance issue:

"3.8 **Demand and supply match**

Thank you for confirming that TW will be charging AWL should a shortfall occur between the water AWL supplies into the network and AWL customer demand and does not propose to reimburse AWL for water supplied into the network that is not consumed by AWL customers. This neatly ensures that a new entrant is placed in a no win situation and where over provision occurs directly benefits the incumbent. This is clearly untenable and we believe will act as a disincentive to competition. You will presumably be aware of the precedents set in the gas industry where Shippers, who are often affiliated with producers, arrange for the transport of gas from entry points to exit points within the Transco network. Currently, on a daily basis, the balancing of Shippers inputs and outputs is undertaken. Shippers who have over provided (or 'cashed out long') are compensated for any over provision by Transco. Shippers who have under provided (or 'cashed out short') are charged for this under provision by Transco. This regime is arranged to provide the necessary incentives to encourage the Shippers to minimise their imbalance, the compensation for over-supply is less than the price on the market. The important point is that over provision is recognised as a natural occurrence and needs to be compensated if competitive market conditions are to exist. I look forward to the defence of your position."

95. On 8 March 2001 Thames indicated in a letter to Enviro-Logic that the issue of the large user discount was under review following informal consultation which Thames had had with the Director on this subject. On the supply/demand balancing issue, Thames stated:

"**3.8 Demand and supply match**

(a) TW, as the incumbent, expects an entrant to supply water into the network to match the demand profile of its customers. An entrant should not supply water into the network that is not required by its customers. Small fluctuations from the daily demands of the entrant's customers would be accommodated by TW by the routine operational management of the network.

(b) As a part of the routine operations, we would agree with AWL the small operational variation band around the normal daily demand of their customers. Taking into account the small quantity of water being supplied, we further proposed, in our letter of

12 January, a once a month balancing process. This process could indicate either a shortfall or over-supply in the month. TW do not envisage any financial transactions as a result of this routine monthly balancing process. We would expect AWL to adjust the quantity of water into supply to retain the balance within the operational band.

(c) In exceptional circumstances the balancing process could indicate that the consumption of an entrant's customers far exceeds the amount of water supplied by the entrant. TW would have supplied these additional requirements of the entrant's customers and as such we expect the entrant to reimburse us for the quantity of water supplied. Where an entrant's customers consume an amount significantly less than that expected by an entrant, we suggest that this is a matter between an entrant and its customers. TW would not pay for any over-supply into the network."

96. On 18 April 2001 Enviro-Logic apparently complained again to the Director but the Tribunal does not have a copy of that document. Little then appears to have happened until, in a letter to Enviro-Logic dated 1 August 2001, Thames proposed that the charge for its role as a supplier of last resort, should be agreed, without prejudice, as an annual charge of £10,000, subject to review once both parties gained experience of the operation of the boreholes. Mr Jeffery replied on 7 August 2001 that he had reservations about this suggestion.

97. Thames also stated in its letter of 1 August 2001 that "[w]e expect applicants requesting access to our network to provide reasonably specific proposals. Our experience to date seems to have been responding to speculative requests". Enviro-Logic responded to this point in its letter of 7 August 2001 as follows:

> "You refer to the need to respond to "speculative requests". As you know, these are established sources where Enviro-Logic has invested time and money in securing access and proving quantity and quality. We have evaluated options for putting the water into beneficial supply and found that we need to access the Thames Network in order to do so. Seeking information that ought to be available to all potential Entrants, does not appear to me to constitute a speculative request, and you are aware that Ofwat share this view."

98. The Director wrote to both Enviro-Logic and Thames requesting considerable further information on 29 August 2001.

Thames' letter of 21 September 2001

99. Thames replied by letter of 21 September 2001 to the Director's letter of 29 August 2001, supplying the information requested, although it appears that this letter was not disclosed to Enviro-Logic until 2004. Thames also commented in that letter that although it had used an average cost approach to network access pricing, it was aware that there was "a growing body of opinion" in favour of a pricing approach known as the Efficient Component Pricing Rule (ECPR), which, if adopted, would lead to a different (and by implication higher) access price. Thames considered that it would be sensible for the determination of Enviro-Logic's application to reflect a national approach to pricing rather than create a possible anomaly.

100. In response to the Director's questions on the relevance of the large user tariff, Thames stated in its reply of 21 September 2001 that:

> "(i) Two of the customers [identified by Enviro-Logic] currently enjoy the benefits of a large user tariff. For these customers our network access charge will be reduced to reflect the large user tariff. Our large user tariff currently provides customers with the benefit of reduction of up to 27% on the standard rate – depending on the volume consumed. The access charge to an entrant will be structured similarly in accordance with the volumes used. For customers not entitled to a large volume tariff, the standard access charge will apply. In the mixed customer situation we believe [Enviro-Logic's] application represents, access charges will reflect the volumes consumed by each customer on each site.

101. In response to the Director's questions concerning supply/demand balancing, Thames responded as follows in its reply of 21 September 2001:

> "(i) The balancing period is open for discussion. We would not anticipate it to be less than monthly physical balancing with financial reconciliation six-monthly.
>
> (ii) We have asked Enviro-Logic to make inputs into our system to match their projected demands from the customers. Their discussion with those customers should have given them opportunity to assess the demand

profiles. Within our Network Access Agreement we have described a process for ready adjustment to profiled demand (essentially just let us know!) and we have included negotiation of upper and lower thresholds around the profile to account for normal variation in demand. This approach mirrors on a small scale the network balancing process we adopt daily to match supply and demand – i.e. we predict aggregated demand and generate supply to match. Variations are accommodated by some buffer storage at treatment works when demand is temporarily less than predicted with corresponding reduction in production rate. In the event of demand exceeding projections, water is taken from a buffer and the plant production is increased. This approach provides for an efficient and secure supply.

In ELL's case we are not asking them to include buffer storage (though this would be the preferred approach) but will accommodate their daily variances (up to the thresholds to be agreed) within our overall system, reconciling the excesses and shortfalls over an agreed period to ensure that there is neither under-nor-over-recovery of charges for the volumes actually transported.

If ELL has a predictable and consistent surplus of water available we will be happy to discuss with them options to purchase this as a separate negotiation. There is however no value to us from unpredictable, intermittent inputs into a part of our network. Surplus water is likely to be available when least needed, and the hydraulic management of the system is hindered by water being injected into the system when not required. The effect of this will be felt by the customers close to the point of entry.

(iii) We would not see it as appropriate to reflect in an access price possible benefits of any available water; the intermittent and unpredictable nature of sporadic surpluses would make it impossible to value. As described above, if a reliable, consistent surplus is available we will be happy to discuss this as a separate commercial item."

Further correspondence in 2001

102. In its letter to the Director of 24 September 2001, Enviro-Logic complained that an access price of 27p/m³, when added to the cost of resources and treatment, would mean that Albion's price to its customers would have to be above Thames' standard tariff. As regards the large user discount, Enviro-Logic contended that the costs of distribution

to large user customers through the large mains network should exclude the costs of maintaining the local distribution system.

103. In relation to over- and under-supply, Enviro-Logic stated in its letter of 24 September 2001 that Thames had the distribution capacity and assets to balance diurnal peaks in water supply and further added:

> "Albion Water's view is that the benefit received by Thames in respect of the sources related to this application may be measured by the LRMC of resource and treatment for the area (42p/m^3). The rationale for this view is that in the London Zone, Thames has a supply deficit. In other areas where there is a supply surplus, Albion Water accepts that there should be symmetry between charges for over or under-supply. Further, where new customers are involved, Albion Water could accept that under-supply to its own customers should be chargeable at LRMC."

Enviro-Logic reiterated both the above points in a letter to the Director dated 5 December 2001.

104. In a letter to Dr Bryan of 25 October 2001, following a meeting on 18 October, the Director stated:

> "We agree that new resources, particularly in the Thames area, have a value and that competitors have a strong opportunity to offer net benefits to customers."

The Director asked to be kept informed of Enviro-Logic's various proposals, but emphasised the importance of good, transparent communication between Enviro-Logic and the Director's staff, and of Enviro-Logic providing well-considered complaints. Dr Bryan in his reply stated that he was comforted by the Director's description of the efforts being made to improve the training and expertise of the Director's competition team.

The large user discount issue

105. Further correspondence took place between the Director and Thames between October and December 2001. In particular, this correspondence focussed on Thames' intentions with regard to large user discounts. In a letter to Thames on 31 October 2001 the

Director asked whether Thames intended to reduce the access price for entrants seeking to serve large users which would correspond with the reductions offered to Thames' customers under the large user tariff. In a letter dated 13 November 2001, Thames stated that the reduction in costs associated with use of the large pipe network only was, on average, 27% and indicated that it would be prepared to apply the same discount to a network user proposing to use only the large pipe network, resulting in an access price of 19.86p/m³, plus a supplementary charge which would depend on volumes consumed. In that letter Thames again stated that it was reviewing its approach to pricing, with a view to adopting an ECPR approach, as distinct from an average accounting cost approach.

106. On 23 November 2001 the Director replied to Thames stating:

> "If you move away from an average accounting cost method, your new approach must still be consistent with how you charge your existing customers. We would be concerned if you could not demonstrate that this was the case. Compliance with the Competition Act remains the incumbent's responsibility."

107. The Director further maintained the position that in its access pricing as regards large users Thames should maintain the same position as it adopted in its tariff pricing. The Director said:

> "**Discount applied for large users**
>
> We note that for large users you propose a 27% discount 'to the normal access charge resulting in an access charge of 19.86 p/m³ plus a supplementary charge (which by implication would match the additional annual charge to large users).
>
> However, we have difficulty with your approach. The large user discount is based entirely on savings from non-use of the smaller distribution system. And you have identified these in terms of a p/m³ reduction from the standard tariff. Therefore, to be consistent, the same p/m³ reduction should apply to the standard access charge. In any event, the cost of resources and treatment is the same for all users. After taking this cost out of the figures, a percentage reduction in distribution charges would be higher than 27%.
>
> In terms of prices for 2000-01, an access charge of 27 p/m³ input plus 23.6% leakage allowance is equivalent to 33.4 p/m³ delivered. The differential between Thames' standard volumetric rate of 61.59 p/m³ and the large user rate of 44.96 p/m³ is about 16.6 p/m³ delivered (offset by the additional

annual charge of £8,315). This differential is intended to reflect lower distribution costs in respect of large users. So, in terms of 2000-01 prices, we would expect an access charge for large users of 16.8 p/m³ delivered (ie 33.4 less 16.6) or 13.6 p/m³ input (ie 16.8 divided by 1.236) plus an annual charge of £8,315.

To avoid any accusation of anti-competitive behaviour, and to maintain a revenue-neutral approach (in respect of distribution costs), we would expect the same approach to apply in respect of very large users.

Incidentally, we note that Thames' cost analysis of 22 November 2000, supporting its large and very large user tariffs for 2001-02, would result in even greater p/m³ differentials.

This is an important issue, which will apply within the ECPR approach as it does within the accounting costs approach. Please let us know by 7 December whether Thames is ready in principle to adopt the p/m³ approach as above. At the same time, please advise us when you expect to complete your review of your approach to setting access prices. If you have any queries over the arithmetic please let me know by 30 November."

108. By its letter dated 5 December 2001 Enviro-Logic sent various calculations of its expected financial returns to the Director. These figures appear to show that Albion's proposals would be profitable only if Albion received a substantial credit for the benefit to Thames of additional resources.

109. In its reply of 10 December 2001 to the Director's letter of 23 November 2001, Thames expressed concern that the practical effect of entrants being able to target customers selectively with common carriage could lead to a situation in which the undertaker would lose revenue, but would save few costs, the result being, according to Thames, to raise costs for the remaining customer base. Nonetheless Thames stated, on the large user discount issue:

> "4. You ask if we are ready in principle to adopt the p/m³ approach that you have outlined. As you will have noted from our initial comments we have serious concerns over the consequences of such an approach. However, if the alternative is that you would determine our proposed percentage reduction approach as anti-competitive under the Competition Act, we will have no option but to consider adopting the approach you have outlined despite the considerable drawbacks this could entail for the customers as a whole."

110. By letter of 20 December 2001 the Director indicated that he expected Thames to quote a revised access price taking into account a large user discount by 22 January 2002.

The revised access price

111. On 11 January 2002, Thames wrote to Enviro-Logic offering to provide an access price based on its large user tariff. The indicative large user price offered by Thames was 13.6p/m³ plus an annual supplementary charge of £8,315. Its "standard tariff" access charge would remain at 27p/m³. Thames stated in this letter that these were "indicative prices" reflecting access to the network only and Thames retained the right to vary the prices during negotiation. Thames also indicated that its current approach to pricing would not necessarily be followed in future negotiations.

112. In a letter sent by Thames to the Director on the same day, 11th January 2002, Thames expressed disappointment that the Director had not responded to its concerns on the application of large user discounts to network access prices. Thames also expressed concern that pricing for network access could (according to the Director) be carried out using various different bases of charge, each of which generated a markedly different price.

113. On 14 January 2002, Mr Jeffery called the relevant official of the Director to acknowledge receipt of the revised access price. According to a note of this telephone conversation prepared by the Director's official, Mr Jeffery wished to say "a big thank you to Ofwat" and had commented that "on balance the price looked good", but expressed some concerns about the fixed element of the charge. Mr Jeffery also inquired about progress made by the Director on Albion's other complaints. On the same day, Dr Bryan wrote to Thames, acknowledging the revised prices and indicating that Albion "will be moving swiftly to progress arrangements for common carriage while we consider the details of that offer".

114. A further letter from Mr Jeffery dated 28 January 2002 to Thames raised a number of matters he believed to be outstanding, including: (i) Thames' position on partial supply of customers; (ii) Thames' approach to Albion's requested inset appointment; (iii) Thames' insistence on financial bonds or guarantees from Albion; (iv) the issue of

demand and supply match; (v) financial arrangements for over- or under-supply; (vi) supplier of last resort charges; and (vii) the benefit to Thames from the supply of additional water into the London area which is in deficit.

115. Mr Jeffery's letter of 28 January 2002 to Thames was also forwarded to the Director by Enviro-Logic. The Director responded on 6 February 2002, commenting that

> "[Your] letter notes that Thames Water's revised offer provides you a way forward. I hope that the rest of your negotiations proceed smoothly. We will be writing to Jerry [Bryan] separately on the remaining issues in the complaint…now that the key issue of access price has been resolved".

116. An e-mail sent by Dr Bryan on 22 January 2002 records Dr Bryan's view of a conversation he had had with a contact at Ofwat, Julie Cooper: "She asked about our response to Thames' high volume access charge and when I asked how far they had to bend Thames' arm she replied "we broke it"."

V THE DIRECTOR'S DECISIONS

117. In a letter addressed to Dr Bryan dated 8 March 2002, the Director responded to the various complaints in the following terms:

> "Dear Jerry
>
> **COMPETITION ACT 1998: COMPLAINT BY ENVIRO-LOGIC AGAINST THAMES WATER UTILITIES LTD RELATING TO ACCESS FOR COMMON CARRIAGE (NEW BATH HOUSE AND ALBION YARD)**
>
> On 10 January 2001 you complained about Thames Water Utilities Ltd ("Thames") in relation to access for common carriage (Bath House and Albion Yard). You confirmed your complaint in your 24 September 2001 letter.
>
> The points of your complaint were:
>
> 1. The price Thames proposed for network access was excessively high.
> 2. Thames should apply a large user discount to its access price to reflect the lower costs of supplying large users.
> 3. The price sensitive nature of some elements that make up the access price allows Thames to create an excessively high price.
> 4. Thames intends to charge for under-supply, where customers' demands are not met over the balancing period, but will not provide an equivalent credit for over-supply.

5. Thames refused to provide an indicative access price during the period from 31 May 2000.

At this time we consider that no further work on your complaint is justified for the reasons set out below. We will close this file by 22 March 2002, unless we hear from you otherwise, with relevant information which would justify further work on our part.

Complaint 1 - The price that Thames proposed for network access is excessive.

You claimed that the effect of Thames' initial indicative price was to prevent competition, since adding the access price to the published Long Run Marginal Cost (LRMC) of London resources and treatment takes costs for competitors above the current standard Thames' tariff.

We reviewed the methodology behind the access price and wrote to Thames about its approach. On 11 January 2002 Thames sent you its revised access price. This price took account of the concerns we had expressed to it over its approach and is consistent with Thames' large user tariff.

Complaint 2 - TMS should apply a large user discount to its access price to reflect the lower costs of supplying large users.

As above, we reviewed Thames' methodology and requested that it apply a discount consistent with that it applies in its large user tariffs. This has been done in the revised access price.

Complaint 3 – The price sensitive nature of some elements that make up the access price allows Thames to create an excessively high price.

We have not seen any evidence that Thames has failed to demonstrate reasonable transparency and provide you with sufficient detail to assess the price it offered. We expect undertakers to demonstrate that charges are consistent with current tariffs, but not to disclose all price sensitive information. Thames has done this. In any case, we have access to some of the price sensitive information, and we have seen no evidence of any excessive pricing in this instance.

Complaint 4 – Thames intends to charge for under-supply where customers' demands are not met over the balancing period, but will not provide an equivalent credit for over-supply.

There is no evidence to suggest that Thames will get significant benefit from this supply, despite the supply zone deficit. Over-supply in such instances has the associated costs of balancing and buffering. If your new sources provided significant benefit to Thames, then it might be reasonable for Thames to give credit for over-supply. However, there is no information to suggest that this is the case. If a balancing system is required, then it is reasonable that there will be a cost associated with it.

Complaint 5 – Thames refused to provide an indicative access price during the period from 31 May 2000 to 24 October 2000.

We were concerned about the time it took for Thames to provide a price. However, a price was provided rapidly on our intervention. In 2000 common carriage policies, codes and prices were still being developed. As

such the delay does not appear to be sufficiently unreasonable to justify further work under CA98 on our part."

118. Mr Jeffery of Enviro-Logic wrote to the Director on 21 March 2002 indicating that, in his view, it was not appropriate for the Director to close his file at that time. Mr Jeffery acknowledged however that "substantial progress" had been made in addressing Enviro-Logic's concerns, and requested a meeting to discuss whether the remaining concerns could be dealt with outside the official complaints process. Mr Jeffery indicated, in relation to Enviro-Logic's excessive pricing complaint, that he would be "happy to accept that no further work is justified" if the Director was able to confirm that Thames' proposals were consistent with the latest June return data supplied to the Director by Thames and the Director's Regulatory Accounting Guidelines (RAGs). Mr Jeffery also asked that the file remain open until Thames had explained the basis for the fixed charge it proposed to apply. Mr Jeffery also expressed his reservations about the Director's treatment of the delay in issuing an access price between 31 May 2000 and 24 October 2000.

119. On the issue of over- and under-supply, Mr Jeffery said:

> "**Complaint 4 – Thames intend to charge for under-supply where customers' demands are not met over the balancing period but will not provide an equivalent credit for over-supply.**
>
> I find it difficult to accept your conclusions on this complaint, in the light of Ofwat's own Access Code Guidance, paragraph 2.3.5, which requires the 'method of charging/reimbursement for over- and under-supply by an entrant to be symmetrical.'
>
> Please advise me if Ofwat policy has changed in this matter and if so what reasons exist for taking an approach that is diametrically opposed to that of other competition regulators. I wish the file to remain open on this matter pending further consideration."

120. The Director closed his file on 22 March 2002 and informed Mr Jeffery of Enviro-Logic of this in a letter dated 26 March 2002, on the basis that the Director agreed with Mr Jeffery's suggestion "that [the] remaining concerns can be addressed outside of the formal complaints procedure".

121. The Director also informed Thames of the closure of the file on 26 March 2002 in terms similar to the letter to Enviro-Logic of 8 March 2002.

122. Mr Jeffery contacted the Director's officials by telephone on 5 April 2002 expressing some concerns over the Director's decision to close its file and the brevity of the letter of 26 March 2002 from the Director.

123. According to a note prepared by Ofwat, Ofwat's response to this was as follows:

> "[Julie Cooper of Ofwat] explained that we had not made a decision on this complaint and so a lengthy response had not been appropriate. We were aware that if we had made a decision then it may have been appealable, as the OFT had found in its Bettercare case, and a long detailed response could be misinterpreted as a decision. However, [Julie Cooper] understood that [Malcolm Jeffery] should pursue his view if he felt it had not been considered. [Malcolm Jeffery] noted that if he felt that we had looked at the issues that had been raised, then he was content that the case could be closed."

124. A substantial part of the ensuing conversation appears to have concerned the issue of over- and under-supply. Ofwat's note of the conversation states:

> "Although the approach to pricing for over and under-supply should ideally be symmetrical, [Malcolm Jeffery] took the point that there was a cost to the incumbent associated with over-supply from an entrant. He agreed that the volume of the source being used by an entrant would be relevant. A large reliable source would be a benefit to the incumbent, and might offset the cost of balancing over-supply, but a small sporadically available source would be of little value to the incumbent. […]
>
> [Malcolm Jeffery] made the point that small water sources can be most efficiently run by the entrant if they are used on a steady state basis up to their abstraction capacity. However this did not match customer requirements. He said this was likely to be the case for many entrants. [Julie Cooper] noted that this was a physical constraint on competition in general, if that was the case. It was not really down to the conduct of an incumbent. Such sources would, by their nature, require a balancing service. Although this was not appropriate to pursue within the context of the complaint, it was agreed that it could provide a relevant consideration for entrants".

125. Correspondence between Thames and Enviro-Logic also continued sporadically over the next several months. On 15 April 2002, Thames indicated that its latest access prices would be published on the Ofwat website from 8 May 2002. However, at this point, the prices quoted by Thames for access were based on a different approach to the calculation of access prices, namely the Efficient Component Pricing Rule (ECPR). It appears that Thames' ECPR price was some 31.9p/m³, as compared with 13.6p/m³ under the average accounting cost approach.

126. However, Thames did confirm, in a letter of 31 July 2002, that the prices quoted to Enviro-Logic in respect of its prior application for access would be honoured. In the same letter, Thames stated:

> "On the question of over-supply, our position remains as we discussed some time ago. We will provide for both over and under supply within the agreed balancing period, and we will reconcile these to a net position. We have also set out within our Access Code, that there will be flexibility for the entrant to determine the volume of water needed by the customer and to vary that volume in the light of experience. We do propose in our Code to allow an agreed margin above and below that volume to create an 'envelope' within which the customers' supply/demand characteristics can be accommodated. Outside of the envelope and subsequent reconciliation if the demand from the customer results in water being taken from us then this need should be paid for. We will be providing water in response to a defined and actual need.
>
> The position on over-supply is different. Again, outside the envelope and reconciliation, the water put into supply is not the result of a specific need. For the majority of the time it will be water which is surplus to requirements. In previous correspondence we have indicated that if you have a reliable continuous surplus of water we would be happy to enter into discussions with a view to possibly purchasing the surplus. That remains our position.
>
> If we were to follow the logic of your proposition of equivalent payment for over-supply as for meeting under-supply demand it would lead to a bizarre outcome. Anyone with water inside our boundary could acquire a customer to take a minimal amount of water, then pump the excess into our network and receive the retail price for the water. This would be irrespective of whether there was demand for the water, and be provided only when the owner of the water chose to supply it.
>
> At times when the incumbent has surplus water – which is most of the year for most years – the cost to the incumbent of this

> water will be far in excess of the marginal costs of its own production – the short run marginal costs in most circumstances. Overall this increases costs and is an uneconomic outcome. Furthermore in times of drought (the dry year), the likelihood of there being surplus water available is reduced, so when demand is highest and the water would have greater potential value there is every chance that the water would not be provided.
>
> In water resource terms, it would be better to leave the surplus water in the ground and to tap it when there is a dry year, rather than use it in years of surplus. This is the principle that underpins artificial re-charge and conjunctive use of water resources."

127. On 6 August 2002 a formal request pursuant to the requirements of section 47 of the 1998 Act, as in force at that time, was submitted to the Director by Enviro-Logic on the basis that, in the light of this Tribunal's judgment in *Betttercare*, cited above, the Director had taken an appealable decision under the Act. Enviro-Logic requested that he withdraw or vary his decision of 6 March 2002 on the issue of the supply/demand balance. The Director's treatment of the issues around over- and under-supply was challenged by Enviro-Logic in the following terms:

> "Ofwat guidelines indicated that the charging arrangements relating to overs and unders should be fair and transparent, and I believe that it is recognised that this implied symmetry in the calculation of cost and of benefit relating to the value of new resources. I believe that the arrangements proposed by TWUL are unfair, particularly when one views concurrently the engineering, operational, and commercial aspects of common carriage projects. The following paragraphs highlight the way in which the proposed charging arrangements become anti-competitive when all aspects are taken into account:
>
> - TWUL expects AWL to supply water into the network to match the demand profile of its customers including an allowance for leakage (TWUL letter to AWL, 8 March 2001)
>
> Incremental sources are most efficient and effective used on a continual and steady output basis. A requirement to match the customers' profiles would result in an inefficient design, either by involving significant storage requirements, or by not using all of the available water licensed for abstraction. TWUL itself needs to match customer profiles in aggregate, but will seek to maximise efficiency by pumping at constant rate wherever possible. Its distribution network and storage reservoirs are designed to assist in this aim. With a constant input rate it is inevitable that overs and unders will occur within a defined balancing period, particularly when seasonal variations occur. I accept that a charge is appropriate to reflect the

value of the commodity 'bought' or 'sold' by the network operator to balance the system.

- Where the consumption of entrants' customers exceeds the amount supplied by the entrant, TWUL would have supplied those additional requirements and as such expect the entrant to reimburse TWUL for the quantity of water supplied. Where an entrant's customers consume an amount significantly less than that expected by an entrant, TW would not pay for any over-supply into the network.
  (TWUL letter to AWL, 8 March 2001)

The lack of reciprocity is not consistent with the approach adopted in other network balancing regimes. Under- or over-provision on a daily basis is unavoidable and is recognised elsewhere (gas and electricity sectors). Incentives may be necessary to reduce the size of imbalances, and therefore minimise costs to TWUL, as the network operator. Nevertheless, I believe that the arrangements need to recognise the distinct roles of TWUL as Network Operator and as Water Supplier. The relationship proposed with Albion Water as Entrant is dissimilar to the relationship that pertains with TWUL as Water Supplier and as proposed acts to disadvantage Albion in the related market for the supply of water. I believe that symmetry in charging for over and under-supply by an Entrant is fundamental to the fair and non-discriminatory operation of the network.

- TWUL are not prepared to accept a common carriage agreement on the basis of partial supplies to some of AWL's customers and expect AWL to supply the quantity of water to match the peak demand of AWL customers (21 December 2001).

One way of dealing with the issue would be to allow more flexibility in the application of aggregate volumes from the new source. This could be achieved either by being able to add additional customers during the contract period (although I suspect that this would require further network modelling and hence, expense), or to allow partial supply to individual customer premises. This latter approach could be used constructively so that the Entrant could balance its supply with the aggregate demand from its customers.

We need to bear in mind that any new source has a finite volume available for abstraction per year. TWUL in both denying partial supplies – effectively not allowing AWL to balance itself – and in denying symmetrical reimbursement/charging for under and over supplies is financially penalising AWL and ensuring that the efficiency of the new source is not maximised. I contend that this is an abuse of their dominant position and anti-competitive.

I therefore find it difficult to accept your conclusions on this complaint.

- Ofwat concludes that there is no evidence that TWUL will get a significant benefit from over-supplies by AWL despite a supply zone deficit. I would like to see the evidence to support this conclusion. I believe there is evidence of a measurable benefit to TWUL. TWUL has indicated a short run avoidable cost of 3p/m^3 relating to resources and treatment; a long run average incremental cost of deferring

resources and treatment expenditure as result of new entrant's water of 22.2p/m³; and a long run marginal cost for resources and treatment of 45p/m³.

- Ofwat also concludes in the letter of 8 March 2002 that 'over-supply has associated costs of balancing and buffering'. I would like to see the evidence to support the view that there are costs and if so an indication of where those costs fall on TWUL, for instance on the supplier of last resort function, the network operator function or the supply function.

Ofwat's recent Access Code Guidance, on the issue of balancing (2.3.6), states that where there is a significant breach of agreed inputs '…the company must be fair and transparent in how it calculates the value of the cost or benefit.' Evidently in this case, TWUL is acting unreasonably, in being neither fair nor transparent (TWUL has not indicated how they will charge for under-supplies by an entrant)."

128. The section 47 request of 6 March 2002 was made on paper headed "Enviro-Logic" and was signed by Mr Jeffery, although throughout it referred to negotiations between Albion and Thames, and referred to the complaint of 7 January 2001 as being lodged by Albion.

129. On 15 November 2002, the Director wrote to Mr Jeffery, indicating that he had been awaiting the judgment of this Tribunal in *Freeserve*, cited above, before considering whether his previous correspondence amounted to an appealable decision.

130. In a letter of 20 February 2003 to the Director, again written on Enviro-Logic notepaper, but this time signed by Dr Bryan, it was acknowledged that the section 47 application was limited to the complaint on under- and over-supply, referred to as "complaint 4" in Ofwat's letter of 8 March 2002.

131. Following further correspondence with Enviro-Logic, on 31 March 2003 the Director published his letters of 8 March 2002 to Enviro-Logic and 26 March 2002 to Thames on the basis that views expressed in those letters amounted to a decision that the 1998 Act had not been infringed. That publication was accompanied by a summary of the decision:

"Notice of decision of Director General of Water Services No CA98/01/2003

Thames Water Utilities Ltd/Bath House and Albion Yard

31 March 2003 (Case CA98/00/54)

SUMMARY

The Director General of Water Services ("the Director") received a complaint under the Competition Act 1998 ("CA98") from Enviro-Logic Ltd ("Enviro-Logic") against Thames Water Utilities Ltd ("Thames Water"). Thames Water is a licensed water undertaker under the Water Industry Act 1991. Enviro-Logic wanted to use part of Thames Water's water supply network to convey water from two boreholes at Bath House and Albion Yard (operated by Enviro-Logic) to new customers of Enviro-Logic. The use of an undertaker's water supply network in this way is known as "common carriage".

Enviro-Logic's complaint consisted of the five points set out in the attached correspondence. For example, Enviro-Logic complained that the price that Thames Water was proposing to charge for conveying the water through its network (the "access price") was anti-competitive because its effect was to prevent competition, since adding the access price to Thames Water's published Long Run Marginal Cost ("LRMC") of London resources and treatment took costs for competitors above the current standard Thames Water tariff. LRMC is the change in total costs per unit change in output, over the long run. It may be estimated as the unit costs associated with supplying larger volumes of water, or the unit cost savings associated with supplying lower volumes. Further information about the use of LRMC is contained in paragraph 4.13 of the CA98 Guideline "The Application in the Water and Sewerage Sectors" and the Director's open letter to all Managing Directors of Water and Sewerage Companies and Water Only Companies dated 8 May 2001 ("MD 170").

Enviro-Logic also complained that the access price that Thames Water was proposing to charge was anti-competitive because Enviro-Logic claimed that Thames Water intended to charge Enviro-Logic for under-supply, but would not provide Enviro-Logic with an equivalent credit for over-supply. By way of background, during negotiations Enviro-Logic and Thames Water discussed what would happen if Enviro-Logic were to supply too much or too little water to meet the demands of Enviro-Logic's customers. In particular, they discussed how this should affect the access price that Thames Water was proposing to charge Enviro-Logic.

It is not always possible to input a constant volume of water from boreholes. Even if Enviro-Logic could input a constant volume of water from the boreholes into Thames Water's network, the demands of Enviro-Logic's customers might vary from time to time. Where the volume of water input into the network by Enviro-Logic was less than the demands of Enviro-Logic's customers ("under-supply"), the shortfall would effectively be supplied to those customers by Thames Water. Similarly, where the volume of water input into the network by Enviro-Logic exceeded the demands of Enviro-Logic's customers ("over-supply"), Thames Water would receive a volume of additional water into its network. The system for dealing with over supplies and under supplies is known as a "balancing system". The question of whether there is an over-supply or under-supply is usually assessed by considering the overall position over a defined period (the "balancing period").

> Enviro-Logic claimed that over-supply would benefit Thames Water because there was a supply zone deficit in the London area where the two boreholes were located. A "supply zone deficit" is where there is a risk that a licensed water undertaker would not be able to meet customers' demands for water during a dry year in the relevant area. The attached letter dated 8 March 2002 to Enviro-Logic refers to the costs of "buffering". "Buffering" means using storage facilities (known as "buffer storage") to balance supply and demand. When demand is temporarily less than the volume of water being supplied through the network, the excess water is stored in buffer storage. When demand increases, water is taken from the buffer storage to increase the volume of water being supplied.
>
> Following an exchange of correspondence with Enviro-Logic, the file on the complaint was closed. The Director then received an application under section 47 of CA98 from Enviro-Logic in relation to the fourth point of its complaint. In its application, Enviro-Logic requested that the Director withdraw or vary his decision that Thames Water had not infringed the Chapter II prohibition of CA98 in intending to charge for under-supply where customers' demands were not met over the balancing period, but not to provide an equivalent credit for over-supply.
>
> The Director has concluded that the views put forward in a letter dated 8 March 2002 to Enviro-Logic and a letter dated 26 March 2002 to Thames Water amounted to a decision that the Chapter II prohibition had not been infringed."

132. Ofwat also wrote to Dr Bryan on 7 April 2003 indicating that, following publication of the Director's decision, the section 47 application would be progressed.

133. On 11 April 2003, on Enviro-Logic's notepaper, supplemented on 25 April 2003 by a letter on Albion's notepaper, a further section 47 application was made, requesting that the Director's decision in respect of the other complaints dealt with in the decision published on 31 March 2003 should also be withdrawn. This further application emphasized, in particular, that it had taken over a year for Thames to offer a revised access price based on the large user tariff following Albion's initial complaint, and that the Director had intervened to convince Thames to lower its price before the new price was offered. In addition it was contended that it was not correct for the Director to have found that Thames did not infringe the Chapter II prohibition in offering its initial price of 27p/m^3.

134. By letter of 1 May 2003, addressed to Dr Bryan at Enviro-Logic, the Director acknowledged receipt of this application

135. There appears to have been little or no progress made in dealing with the section 47 applications until 28 January 2004, when a letter was sent from the Director to Thames requesting further information. In particular this letter asked Thames to expand on the reasons why Thames expected Enviro-Logic to input water into the system to match the demand profile of customers and the circumstances in which it might have been interested in purchasing a supply of surplus water. The letter also asks for further details of Thames' calculations of its access charge of 27p/m³. Thames replied to that letter on 13 February 2004.

136. On 1 April 2004 Ofwat sent a letter addressed to the Company Secretary of Peninsula Water, formerly Enviro-Logic, setting out the Director's "provisional view" that he should reject the section 47 applications. On the complaints concerning excess pricing the Director stated that he was satisfied that Thames' calculation of the access price was consistent with the RAGs and the June Return data. The Director considered that this answered the concern expressed by Mr Jeffery in his letter of 21 March 2001. In relation to the issue of large user discounts, the Director felt that no further work was required on this matter following the offer of a reduced tariff by Thames on 11 January 2002. Ofwat considered that under the 1998 Act no decision had been taken on this matter:

> "From the terms of its letter of 25 April 2003, Enviro-Logic appears to believe, erroneously, that Ofwat has taken a decision that the Chapter II prohibition was not infringed by Thames Water's conduct in initially offering access to the network only at the higher tariff of 27p/m³. In fact we took no such decision. Once the conduct complained of had been resolved, the Director exercised his discretion not to investigate the matter further and not to proceed to reach a decision as to whether or not the Chapter II prohibition had been infringed. This was a matter for the Director's administrative discretion which he exercised properly and reasonably, having regard to the relatively swift resolution of the conduct complained of and the need to prioritise Ofwat's resources."

137. The Director adopted a similar position in relation to the issue of delay and stated that although a delay may, under certain circumstances, amount to a breach of the Chapter II prohibition, the delay in this case did not appear sufficiently unreasonable to justify further work.

138. In relation to the issues surrounding under- and over-supply, the Director stated in his letter of 1 April 2004:

> "Enviro-Logic said that it would like to see the evidence behind the statements in Ofwat's letter of 8 March 2002 that there was no evidence to suggest that Thames Water would get a significant benefit from this supply, and that over-supply in such instances has associated costs of balancing and buffering. In its letter dated 21 September 2001 to Ofwat, Thames Water said that:
>
> > 'If ELL has a predictable and consistent surplus of water available we will be happy to discuss options to purchase this as a separate negotiation. There is however no value to us from unpredictable, intermittent inputs into a part of our network. Surplus water is likely to be available when least needed, injected into the system when not required. The effect of this will be felt by the customers close to the point of entry."
>
> Ofwat did not therefore agree with Enviro-Logic that Thames Water should always provide a credit where there is an over-supply.
>
> Thames Water also explained in its letter of 21 September 2001 that it would accommodate daily variations up to thresholds agreed within the overall system, reconciling the excesses and shortfalls over an agreed period to ensure neither under nor over recovery of charges for volumes transported. Thames Water also said that it was not asking Enviro-Logic to include buffer storage.
>
> Thames Water explained its position in a letter to Enviro-Logic dated 31 July 2002. In the letter of 31 July 2002, Thames Water said that it would provide for over and under supply within the agreed balancing period and reconcile these to a net position. It also said that it proposed to allow an agreed margin above and below the volume of water that an entrant decided its customer needed within which customers' supply/demand characteristics could be accommodated. Thames Water said that outside of the margin and after reconciliation it should be paid for water taken from it, but if Enviro-Logic had a reliable and continuous surplus of water available it would be happy to discuss with Enviro-Logic options to purchase the surplus.
>
> In response to more recent enquiries by Ofwat, Thames Water said in a letter dated 13 February 2004:
>
> > "We have always sought to be flexible in our approach to new entrants and, if it had been suggested at the time we would be happy to consider Thames Water matching the demand profiles of Enviro-Logic's customers and carry

> out the necessary buffering and balancing as if it were Thames Water's own groundwater source."
>
> It appears that discussions between Enviro-Logic and Thames Water in 2001 and 2002 about arrangements for dealing with over and under supplies were, in any case, at an early stage. Thames Water stated in its letter of 13 February 2004 to Ofwat that it had had "minimal discussions with Enviro-Logic on this issue". Thames Water has also explained to Ofwat that it did not receive a reply to its letter of 31 July 2002 to Enviro-Logic and that its discussions with Enviro-Logic about under and over supply did not therefore continue after that date.
>
> The above clarification addresses Enviro-Logic's stated concerns in relation to the information on which Ofwat based its letter of 8 March 2002. Having considered the arguments put forward by Enviro-Logic in its letter of 6 August 2002 and the information provided by Thames Water, we do not consider that any further work is justified or necessary in relation to this complaint. We therefore consider that there is no ground on which to withdraw or vary the decision to close the file on this complaint."

139. The Director's letter of 1 April 2004 was not copied or supplied to Albion. Peninsula Water having indicated on 29 April 2004 that it had no comment to make, the Director sent a formal letter on 11 May 2004 advising Peninsula Water of his intention not to withdraw or vary the decisions in the Director's letters of 8 March 2002 and 26 March 2002.

140. As already stated, as from 19 February 2004 Albion had ceased to be a subsidiary of Enviro-Logic (renamed Peninsula Water) and was controlled by Dr Bryan through Waterlevel Limited. During the course of May and June 2004, the Director maintained, in correspondence with Albion, that he was prepared to deal only with Peninsula Water, not Albion, since the original section 47 applications had been made by Enviro-Logic, not Albion. Dr Bryan maintained that the applications had also been made by Albion, which had been closely involved throughout.

141. In a letter dated 7 July 2004, the Director confirmed that a decision had been made on 11 May 2004 under section 47(4) of the 1998 Act rejecting the section 47 applications. The Director did not intend to publish that decision, and considered that the time period for bringing an appeal against that decision had started to run on 11 May 2004.

VI THE PROCEDURE BEFORE THE TRIBUNAL

142. On 12 July 2004 Albion lodged an appeal against the Director's decision with this Tribunal, without having had sight of the correspondence between the Director and Peninsula Water, or of the Director's earlier correspondence with Thames.

143. Following further correspondence and procedural hearings on 21 September 2004, 8 November 2004 (at which Albion sought a stay of the appeal pending the completion of a tripartite case study between Albion, Thames and the Director) and 24 November 2004, Albion filed an amended notice of appeal on 7 December 2004. The Director's defence was filed on 2 February 2005, and Thames' statement of intervention on 11 March 2005. On 26 May 2005 the Tribunal visited the two boreholes at Albion Yard and Bath House, and also the borehole at the Hammersmith Hospital.

144. At the commencement of the hearing on 20 June 2005, the Tribunal ruled that the issue of delay had not been raised in the notice of appeal, either as regards the initial five month period from 31 May 2000 to 24 October 2000, or as regards the eighteen month period from 31 May 2000 to 11 January 2002, when Thames offered an access price acceptable to the Director: [2005] CAT 23. Consequently the Tribunal has not considered the issues of delay.

VII THE SUBSTANTIVE ISSUES

A. GENERAL

145. There are two main groups of issue remaining in this case, with which we deal in turn. The first group concerns in various ways the initial access price of 27p/m³ quoted by Thames on 24 October 2000. Albion does not now challenge in this appeal the final access price of 13.6p/m³ plus a standing charge offered by Thames on 11 January 2002.

146. The second group of issues concerns in various ways the correctness or adequacy of the Director's finding that Thames did not infringe the Chapter II prohibition by refusing to credit Albion for any surplus water introduced by Albion into the Thames system in excess of Albion's customers' demand, while seeking payment for any under-supply by Albion.

147. In the course of argument on those two main groups of issues, various submissions have been advanced on the true construction of the WA03, the relationship between that Act and the 1998 Act, and on the ECPR approach to pricing. Those issues are currently before the Tribunal in the *Shotton* Case in which we gave an interim judgment on 22 December 2005 [2005] CAT 40. We do not find it necessary to express any view on those points in these proceedings, and it is undesirable for us to do so while that case is still pending.

148. We make some brief comments at the end of this judgment on Albion's further submission that there is a pattern of exclusionary conduct by Thames and other incumbent undertakers which the Director has taken few or no steps to combat.

149. Albion does not take any point on the procedure followed in this case, but we find it unfortunate that this matter should have taken from 7 January 2001 to 11 May 2004 to resolve, over a year passing between the initial complaint of 7 January 2001 and the Director's letters of March 2002, then a further year passing before the publication of those letters with a short further explanation on 31 March 2003, followed by little further activity until the closure of the file in May 2004. Quite apart from evidence in Ofwat's note of 5 April 2002 that at one stage the Director's officials sought to avoid the appearance of taking a decision – presumably so as to avoid an appeal under the Act – the section 47 requests made on 6 August 2002 and 25 April 2003 do not appear to have been followed up with Thames until early 2004, with up to five months elapsing before the Director's final letters to Peninsula Water of 1 April and 11 May 2004. The fact that the latter letters were not supplied to Albion also gave rise to procedural complications and delay that in our view could have been avoided.

150. We mention one other procedural matter. It appears that Thames' letter to the Director of 21 September 2001 was not disclosed to Enviro-Logic prior to 1 April 2004. Thames' letter of 21 September 2001 is of central importance on the issues relating to under- and over-supply dealt with later in this judgment. We think it likely that aspects of this matter could have been resolved sooner if the Director had sought Enviro-Logic's comments on that letter.

151. As regards the substance of the matter, to which we now turn, in *Freeserve.com v Director General of Telecommunications* (*"Freeserve Validity"*) [2003] CAT 5, the Tribunal said at paragraph 114 that in a case such as the present:

> "What, it seems to us, a complainant needs to do is to persuade the Tribunal that the decision is incorrect or, at the least, insufficient, from the point of view of (i) the reasons given; (ii) the facts and analysis relied on; (iii) the law applied: (iv) the investigation undertaken; or (v) the procedure followed."

152. In this case, for the reasons given below, we reach no view on whether Thames did, or did not, infringe the Chapter II prohibition. We concentrate rather on issues of process, and in particular on whether the Director gave adequate reasons for his decision.

B. ISSUES REGARDING THE INDICATIVE PRICE OF 27p/m³

The parties' submissions

153. According to Albion, the initial access price of 27p/m³ offered by Thames Water to Albion on 24 October 2000 was reduced, following the intervention of the Director, to 13.6p/m³ plus an annual supplementary charge of £8,315. This reduced price was not offered until 11 January 2002, following the intervention of the Director who effectively forced Thames Water to lower its access price to the new level. It was stated by the Director's officials to Dr Bryan that they had bent Thames' arm so far that "we broke it" in negotiations concerning the access price (see Enviro-Logic's email of 22 January 2002).

154. Albion submits that Thames' conduct prior to 11 January 2002 was a clear case of abusive conduct and the Director's intervention was clearly on this basis. The price of 27p/m³ was plainly excessive, applying the test in *Napp Pharmaceutical Holdings v Director General of Fair Trading* [2002] CAT 1 at paragraphs 390 to 392. The Director therefore ought to have made a formal finding that in the period 24 October 2000 to 11 January 2002 Thames Water abused its dominant position by offering an excessive access price to Albion.

155. According to Albion, the Director should also have found that the initial access price of 27p/m³ offered by Thames Water to Albion on 24 October 2000 was abusive on the

additional basis that it allowed Albion no margin whatever and was thus a clear case of a margin squeeze, given that no reasonably efficient supplier (or Thames itself) could have entered or remained in the market on the basis of a charge of 27p/m³ for carriage of water through Thames' network, as pointed out in Enviro-Logic's letter of 2 September 2001. The Director himself recognised that this was part of the complaint in his summary published on 30 March 2003.

156. Albion submits that the Director's statements to the effect that he did not conclude, in this case, that the Chapter II prohibition had not been infringed as regards the initial access price offered to Albion, are erroneous. The Director's letter dated 1 April 2004 is inconsistent with the Director's statement, when publishing his letters of 8 March and 26 March 2002 in the public register of decisions under the 1998 Act on 31 March 2003, as follows:

> "the views put forward in a letter dated 8 March 2002 to Enviro-Logic and a letter dated 26 March 2002 to Thames Water amounted to a decision that the Chapter II prohibition had not been infringed."

157. Albion relies in particular on the Director's letter to Thames of 23 November 2001 to show that the Director had clearly considered Thames' price of 27p/m³ to be abusive. Albion submits that the correct course for the Director to follow would have been to make a formal finding that Thames was in breach of the Chapter II prohibition. In the course of submissions (but not in the notice of appeal) Albion invited the Tribunal to make a formal finding to that effect.

158. On the margin squeeze issue, Albion submits that on the basis of: (i) the initial access price of 27p/m³; and (ii) Thames' own estimates of the long run marginal cost (LRMC) of resource and treatment (some 45p/m³) and/or any reasonable estimate of such costs as supplied by Albion in a letter to the Director of 5 December 2001, it would be impossible for Albion to supply water to its customers except at a price higher than Thames' existing tariff. That could give rise to a margin squeeze according to the approach of the Tribunal in *Genzyme v Office of Fair Trading* [2004] CAT 4, the European Commission's *Telecommunications Notice* (OJ 1998 C265/2, at paragraphs 117 to 119) and decision in *Deutsche Telekom* (OJ 2003 L263/9, at paragraphs 106 to 108).

159. The Director submits that this appeal has no continuing relevance and is "stale". If Albion seeks to enter the market in future by supplying water to customers from boreholes via Thames' water supply system the price that it will pay for access to Thames' system would be determined under rules set out in the amended legislation introduced by the WA03. That legislation will govern whether, and if so under what conditions, Albion could even be permitted to introduce any water into Thames' system at all, since section 66J of the WIA91 prohibits unauthorised introductions of water.

160. However, for the avoidance of doubt, the Director does not argue that the decision to close the file on the initial access price of 27p/m³ is not an appealable decision or that the appeal is inadmissible.

161. As to Albion's submission that the Director should have made a formal finding that Thames' conduct prior to 11 January 2002 was clearly abusive, the Director submits that he has no duty to pursue formal infringement proceedings against parties. The initial access price offered to Albion of 27p/m³ was reduced following intervention by the Director, to 13.6p/m³ plus an annual charge of £8,315. Albion gave an indication, in particular in its letter of 21 March 2002, that this latter price was satisfactory subject to checking various matters. Accordingly, the Director's decision to close his file rather than pursue formal proceedings was reasonable. The absence of a formal finding of infringement by the Director does not preclude Albion from claiming damages against Thames.

162. As regards the alleged margin squeeze, the Director submits that this is a separate issue which was not raised during the section 47 procedure, although it is accepted that the original complaint raised this issue. The Director submits that, contrary to Albion's assertions, this case is not comparable to *Genzyme*. In this case, Thames' standard tariff was 61.59p/m³, its large user tariff was 44.96p/m³, plus a fixed annual charge of £8,315 and Albion was initially offered an access price of 27p/m³. Albion therefore had a margin of at least 17.96p/m³ to provide water resource and treatment services, even on the initial access price. The Director submits that on those figures Albion has not shown that the average accounting cost methodology applied by Thames in this case has closed the door to competition. The Director relies on the European

Commission's *Telecommunications Notice,* cited above, at paragraphs 117 and 118 of that Notice.

163. According to the Director, Albion's argument that Thames itself could not have provided water resource and treatment services within the cost of the standard or large-user tariffs if it had charged itself an access price of 27p/m³, is based on Thames' published LRMC for resources and treatment of 45p/m³. The LRMC figure is an estimate of the marginal cost of developing new treated water across Thames' entire London area over 25 years. Its use by Albion does not show that the access price allowed no reasonably efficient competitor, or Thames itself, to enter or remain in the market if charged an access price of 27p/m³.

164. Thames supports the Director, and submits that it would be pointless to remit this matter since the legal position has changed with the coming into effect of the WA03. In any event, the initial access price of 27p/m³, which was only indicative, was not abusive since, at the time, there was no learning or guidance as to how such prices should be calculated: see Case 26/75 *General Motors v Commission* [1975] ECR 1367. Moreover, according to Thames, the issue of the application of the large user discount was not straightforward. There has been no finding of infringement against Thames as regards the price of 27p/m³, and were the matter to be pursued Thames would advance additional arguments to justify that price. According to Thames, the price of 27p/m³ was in any event a generous price, since had the price been calculated on an ECPR, rather than an average accounting cost methodology, the price would have been 31.9p/m³.

The Tribunal's analysis

165. There being no challenge to the access price of 13.6p/m³ plus a standing charge quoted by Thames in January 2002, the issue in this part of the case concerns the Director's treatment of the initial access price of 27p/m³ quoted by Thames on 24 October 2000 and not revised to 13.6p/m³ for some fifteen months until 11 January 2002. That price was itself provided only after the Director's letter of 5 October 2000 expressing concern about Thames' delay in providing any price at all to Enviro-Logic.

166. In the summary published on 31 March 2003, the Director stated that the views put forward in his letters of 8 March 2002 to Enviro-Logic and 26 March 2002 to Thames "amounted to a decision that the Chapter II prohibition had not been infringed." In submissions before us, it was not disputed that the Director had taken an appealable decision that the Chapter II prohibition had not been infringed within the meaning of section 46(3)(c) (as it now is) of the 1998 Act. It was not suggested that there was no such appealable decision as regards the price of 27p/m³.

167. In those circumstances it seems to us to follow that, formally speaking, the Director is to be taken for the purposes of this case to have decided in his letter to Enviro-Logic of 8 March 2002 that the initial access price of 27p/m³ did not infringe the Chapter II prohibition.

168. It is, however, clear from the correspondence that the Director had warned Thames that the initial access price was potentially anti-competitive, on the basis that it did not reflect the discount for large users applicable under Thames' standard tariff. For that reason the Director put Thames under considerable pressure to reduce the price of 27p/m³, albeit that it took a year of correspondence to reach that point. The Director's letter to Thames of 23 November 2001, cited above, makes clear that Thames should offer a large user discount (which would result in an access price of 13.6p/m³). In that letter, the Director, having set out the calculations, said:

> "To avoid any accusation of anti-competitive behaviour, and to maintain a revenue-neutral approach (in respect of distribution costs), we would expect the same approach to apply in respect of very large users."

169. Thames was given until 7 December 2001 to indicate whether it accepted that approach. Thames duly did so, reluctantly, in its letter of 10 December 2001:

> "…if the alternative is that you would determine our proposed percentage reduction approach as anti-competitive under the Competition Act, we will have no option but to consider adopting the approach you have outlined…".

170. The Director replied on 20 December 2001:

> "…our view remains that the large user discount (and super large user discount) should be applied as outlined in my letter of 23 November. To do otherwise would be inconsistent with

> your approach to tariffs for your current customers and could be a breach of the Competition Act 1998.
>
> …
>
> Please confirm the revised access price that you will be offering to Enviro-Logic under the p/m³ approach. Please send the revised offer to Enviro-Logic (copied to us) by 14 January 2002."

171. It is thus clear from that correspondence that the Director's view was that the initial access price of 27p/m³ was potentially an infringement of the Chapter II prohibition unless the large user discount was applied. To the extent that the Director's decision of 8 March 2002 is to be taken to be a decision that the Chapter II prohibition was not infringed in relation to the price of 27p/m³ - which is not disputed on behalf of the Director – any such decision is inconsistent with the contemporary correspondence.

172. It follows that, to the extent that the Director's decision of 8 March 2002 is to be taken as deciding that the Chapter II prohibition was not infringed by the price of 27p/m³, that decision formally cannot stand, on the grounds that any such decision was inconsistent with the Director's view, set out in the contemporary correspondence, that that price was potentially in breach of the 1998 Act.

173. The Director did not, however, proceed to take a formal decision against Thames to the effect that the Chapter II prohibition had been infringed by the price of 27p/m³. Any such decision would have required the Director to continue the administrative procedure against Thames and serve a statement of objections.

174. Formally speaking, the question therefore arises as to whether the Tribunal should remit the matter of the price of 27p/m³ to the Director with a view to the latter considering whether a formal decision under the Chapter II prohibition should be taken, or whether the Tribunal should consider taking any such decision itself under the powers contained in Schedule 8, paragraph 3 of the 1998 Act.

175. In our view neither course would be appropriate, principally since the initial access price was superseded by the later price of 13.6p/m³ on 11 January 2002. Whether the earlier price of 27p/m³ was an infringement of the Chapter II prohibition in 2000 or 2001 does not seem to us to be a question which we could justifiably ask the Director to

reconsider at this distance in time. Albion did not, in it its amended notice of appeal or reply, ask the Tribunal to decide the matter itself, and the Tribunal does not have the material on which to do so, and might have difficulty in obtaining such material, even if that were otherwise appropriate, which in our view it is not.

176. As regards the issue of margin squeeze, having made it clear that any implied finding by the Director that the earlier price of 27p/m³ did not infringe the Chapter II prohibition cannot stand, there is no need for us to address the margin squeeze issue. The relevant principles are in any event before the Tribunal in the pending *Shotton* case.

177. We reiterate, however, that we are not in a position to express a view, one way or the other, on the question whether the indicative price of 27p/m³ was an infringement of the Chapter II prohibition.

178. In all those circumstances it does not seem to us necessary to make any formal order on this part of the case.

C. ISSUES OF UNDER AND OVER SUPPLY

The parties' submissions

179. Albion submits that it is an abuse for Thames to refuse to give credit to Albion for providing a steady supply of water into Thames' network, to the extent that:

    (a) such water is surplus to the needs of Albion's customers and thus available for Thames to supply to other customers; and

    (b) given Thames' current and projected supply deficit, it contributes to the discharge by Thames of its public service obligations to provide a supply of water within its supply area.

180. Albion refers to the Access Code, cited above, which states: "Ofwat expects… the method of charging/reimbursement for over- or under-supply by an entrant to be fair and transparent" (paragraph 2.3.5).

181. Albion submits that the issue of reimbursement for over- and under-supply is not an issue which is of merely historic interest, as suggested by the Director and Thames. The resolution of this issue by the Tribunal will have a significant effect on the feasibility of future competition in the water industry in England and Wales. The asymmetrical approach adopted by Thames (of charging Albion in case of under-supply of water but giving no credit in case of over-supply) and approved by the Director, is manifestly unfair and does not reflect practice in other industries, notably the gas industry, where, according to Albion, network providers recognise the value of additional resources provided by new entrants.

182. Albion submits that it has at all times made clear that it is willing to pay Thames' reasonable charges for: (i) acting as "supplier of last resort"; (ii) providing "balancing services" should that prove to be necessary; and (iii) water supplies actually made to Albion's customers where there is a deficit in the resources provided by Albion. However Albion submits that the policy adopted by Thames represents manifestly "unfair trading conditions" for the purposes of section 18 of the 1998 Act, and that the Director's decision to the contrary should be set aside by the Tribunal.

183. Albion submits that the Director's decision letters of 8 March 2002 and 1 April 2004 were manifestly inadequately reasoned on this issue. The Director's analysis rests on a basic misunderstanding of the facts of this case which concerns a relatively modest but constant supply of water from boreholes at Albion Yard and Bath House which would provide a useful additional resource for Thames that could readily be managed as part of Thames' much larger network.

184. The Director's stance, according to Albion, was strongly influenced by the assertion by Thames in its letter dated 21 September 2001 that there was "no value to us from unpredictable, intermittent inputs in to a part of our network". The Director has not, however, analysed or tested this assertion in any way. Moreover, says Albion, the Director merely states in the decision of 1 April 2004 "Ofwat did not therefore agree with Enviro-Logic that Thames Water should always provide a credit where there is an over-supply". Albion submits that that analysis is manifestly inadequate on its face and erroneous as a matter of fact.

185. According to Albion, its proposal would have resulted in a small (by the standards of Thames' overall network) but constant new supply of water into Thames' network that was broadly in balance with the intended demand of Albion's customers. Albion did not intend, as submitted by the Director, to introduce "unpredictable intermittent inputs into a part of the network". Likewise, Albion intended to use its new water resources to meet a relatively constant demand from local commercial users, and to minimise surpluses. The only material uncertainty in the proposal in the present case was thus the same uncertainty as to consumer demand that Thames already manages in its role as the incumbent undertaker. However, if Albion was supplying at a constant rate – as it is efficient to do – that rate would naturally have to be geared to its customer's maximum demand. In those circumstances what are known as "overs and unders" would inevitably occur. If Albion has to pay for "unders" it is unfair that Thames gives no credit for "overs"

186. In Albion's submission, such "overs" would have relieved some of the pressure on Thames to supply potable water into Central London from its wider network. That would be of obvious benefit to Thames, given the supply deficit. In Albion's submission it naturally follows that Thames should provide Albion with a credit for this resource. At the very least this should be the resource cost of some 3p/m^3.

187. Albion challenges the Director's assertion in his letter of 8 March 2002 that "There is no evidence to suggest that Thames will get significant benefit from this supply, despite the supply zone deficit". Dr Bryan's evidence is that Bath House and Albion Yard when fully commissioned could have an output of 4Ml/d, and in aggregate Albion was investigating boreholes with some 14Ml/d. If the Director had acted appropriately Albion would by now have been able to supply the full 20Ml/d envisaged by the GARDIT strategy with substantial savings to Thames.

188. Albion further submits that since Thames accepts it has a resource deficit in its supply area, the *entire* quantity of water which it inputs into the Thames network provides Thames with a valuable benefit for which credit should be given, as the pressure on Thames to invest in new water resources to discharge its supply obligations is thereby relieved. There is no analysis of these issues in the Director's decision.

189. On this latter aspect, Albion also refers to MD 170 (8 May 2001) which is to the effect that, under an ECPR-based approach, credit should be given for the costs avoided by the incumbent. On that approach too Thames should give credit, at least for the costs of resources and treatment which it had avoided as a result of Albion supplying it with an additional supply of treated water. On the basis of Thames' LRMC for resources and treatment for 2001-2002 of 45p/m³, the access charge would have been nil p/m³ (large user tariff of 44.96p/m³ minus LRMC of 45p/m³). This point, says Albion, would be highly relevant to the future interpretation of section 66E of the WIA91.

190. Alternatively, submits Albion, it would have been appropriate to subtract the resource and treatment costs saved by Thames from the initial access price of 27p/m³. That would give an access price of -18p/m³, on the basis of an LRMC of 45p/m³.

191. Albion further challenges the Director's statements in his letter of 8 March 2002 that "Over-supply has the associated costs of balancing and buffering," and "If a balancing system is required, then it is reasonable that there will be a cost associated with it." Albion says that there is absolutely no evidence of any such costs incurred by Thames in this case.

192. According to Albion, Dr Bryan's evidence establishes that the vast majority of water distribution systems require a balancing mechanism and Thames' London network is no exception. Short-term balancing is provided by service reservoirs located throughout the network, which fill when demand drops and empty when demand rises. The outputs from the major treatment centres in the Thames and Lee valleys are controlled to keep these service reservoirs within their normal operating range. This balancing mechanism is capable of coping with very substantial diurnal variations in flow. According to Albion, the Director is quite wrong to claim that over-supply from these two Albion boreholes would entail further costs. Dr Bryan's evidence is that even the aggregated supply from perhaps 20 borehole sources, could be easily accommodated by Thames within the existing balancing mechanisms.

193. As to Thames' argument, apparently accepted by the Director, that "it would be better to leave the water in the ground and tap it when there was a dry year", that point is not taken in the Decision, according to Albion. In any event, Thames is required to have

sufficient deployable water resources, including "headroom" to meet customer demand, and Albion's surpluses would contribute to that.

194. As to Thames' proposal to enter into a supply agreement if Albion had available a constant supply of additional water, Albion points out that that is a totally different proposition from giving credit for the "overs" part of "overs and unders", and does not deal with the "overs and unders" problem. Albion does not wish to enter into a bulk supply agreement with Thames, but to deal with retail customers. Albion points to the potential contradiction between Thames' willingness to pay (according to Mr Jeffery up to 22p/m^3) for additional water resources when supplied directly by Albion, but not to pay for such resources when they result from "overs" surplus to the requirements of a customer supplied by Albion. The only difference between the two situations, says Albion, is that such a bulk supply agreement does not threaten Thames' position as a retailer (Mr Jeffery's witness statement of 7 December 2004, paragraphs 13 to 15).

195. Finally Albion points out that, in the *Shotton* case currently before the Tribunal, the Director has submitted that new entry in the industry is legitimate when it involves the introduction of new, more efficient, water resources. Albion's business model in the Albion Yard and Bath House cases was to do just that, and yet Albion's complaint was dismissed by the Director in summary terms.

196. The Director submits first, that the issue of credit for the *total* volume of new water resources provided by Albion was not the subject of the administrative procedure. Albion's complaint concerned *surplus* water injected into the system, and whether it was appropriate for Thames to give no credit for over-supply while charging for under-supply: see Enviro-Logic's letters of 24 September 2001, 21 March 2002, and 6 August 2002. In other words, the issue was about "overs and unders". The issue of credit for the *total* value of Albion's new resources did not feature in the section 47 procedure and it is not open to Albion to raise it now.

197. In any event, according to the Director, it is wrong in principle to give credit for avoided costs where, as in this case, the common carriage access price has been calculated according to an average accounting methodology, as opposed to a retail-minus or ECPR methodology. The average accounting cost methodology apportions

the accounting costs attributable to the use of existing assets in providing network access to the new entrant. The incumbent water company charges the new entrant as it charges itself for the use of the relevant assets. The impact of the access agreement on the costs of the undertaker's *other* assets, whether beneficial or detrimental (e.g. if the new entry were to leave the incumbent with stranded assets), is not and should not be taken into account either way.

198. According to the Director, an ECPR methodology for calculating access prices – not used in this case – *does* enable credit to be given for the totality of new resources. This is because this methodology takes as its starting point the retail tariff which *includes* the costs of water resources and treatment. According to the Director, the access charge under this approach is the retail tariff *less* the specific costs which the incumbent undertaker is able to avoid as a result of losing units of sale to the new entrant. However, even with an ECPR approach, the flaw in Albion's argument is that Thames' published LRMC of 45p/m³ is the wrong figure to take, because that does not reflect the cost savings to Thames in this case, notably because these boreholes are too small to enable Thames to defer significant capital expenditure or make other savings.

199. Albion's alternative approach, of deducting the alleged savings to Thames in resource and treatment costs from the access price (initially 27p/m³), is equally incorrect, according to the Director. In that case, submits the Director, the resource and treatment costs incurred by Thames on an average accounting cost basis have already been deducted in arriving at the initial access price, which reflects distribution costs only. To deduct again resource and treatment costs saved would be double counting. Similarly if the customer pays Albion for the water, but Albion also recovers an additional sum from Thames for resources "saved" (even though resource and treatment costs have already been taken out of the calculation of the access price) Albion would benefit from double recovery.

200. According to the Director, Albion's reliance on MD170 is misplaced. Page 13 of that document makes it clear: (i) that LRMC estimates should not be mixed with average accounting costs estimates; and (ii) that where an ECPR approach is used (which was not the case here) LRMC *could* be used to measure avoidable costs, but would not necessarily be used. In any event, Albion, having objected to the high access price

resulting from an ECPR approach, cannot rely on an ECPR approach to mitigate the result arrived at using an average accounting cost approach.

201. The Director further submits it is not correct to assume, simply because there is a resource deficit in the Thames supply area overall, that any and every source of new water, wherever located and whatever its volume, is automatically of value to Thames. The Director accepts Albion's basic premise that Thames does need to increase its capacity in order to cope with drought conditions, and because demand in London is expected to grow. However, the Director does not accept that the Albion Yard and Bath House boreholes would have resulted in a value to Thames in terms of defined expenditure saved on resources or treatment in that locality: a borehole at Mile End explored by Thames had proved unviable according to Thames' letter of 13 February 2004. The possible output of 4Ml/d from Albion Yard and Bath House referred to by Dr Bryan is above the licensed output value of 1.1 Ml/d and is speculative. The overall figure suggested by Dr. Bryan of 14Ml/d would require close investigation of the individual sources before it could be confirmed.

202. The Director submits that Albion's assertion that surplus water provides an "obvious benefit" to Thames is simply incorrect and that he was entitled to find that it had not been established that the injection of surplus water into the network would give rise to a material benefit to Thames that should be reflected in the access price. The basis for the Director's finding was Thames' explanation in its letters of 21 September 2001 and 31 July 2002 of how its network operated, and particularly that there is no value to Thames from unpredictable or haphazard intermittent inputs of water into the network, a matter which is "consistent with basic industry knowledge and common sense". When potential shortfalls in supply are highest, at times of drought, the likelihood of there being surplus water available in the boreholes is reduced. Thames submitted to the Director that in water resource terms it would be better to leave the water in the ground and tap it when and if there is a dry year rather than use it in years of surplus.

203. According to the Director, the Director's guidance in MD170 does not require incumbent water undertakers to purchase surplus water injected into their systems. The incumbent is rather required to assess whether, in the case of under-supply or over-

supply by a new entrant, that breach of agreed inputs is costly or beneficial and to calculate the value of that cost or benefit in a fair and transparent manner.

204. The Director accepts that the effect of introducing extra water is to back up storage capacities in reservoirs, but argues that that does not necessarily confer an economic benefit on Thames, not least because Thames is not in a permanent state of crisis, but only has a potential crisis periodically, every number of years. Although it is a point of fact "not well covered by the documents", the Director submits that any surplus water stored by Thames is not necessarily a benefit, due to leakage or evaporation, "at least to the level that… Albion seems to be suggesting" (Day 2, pp. 40-41).

205. According to the Director, there was no basis for Albion's claim that the Director should have investigated whether the introduction of Albion's surplus water imposed additional buffering or balancing costs, since the Director's position was that it was not shown that Albion's surplus water would confer any benefit on Thames. The question of whether there would be separate charges for balancing or buffering did not, therefore, arise.

206. As regards Thames' willingness to pay a significant sum for a bulk supply, the Director says that that is not surprising where there is a measurable benefit to Thames. The Director refers to a letter from Thames to Albion of 17 April 2003 regarding King's College Hospital, Dulwich, which indicates Thames' willingness to reflect "a large and reliable input" which results in deferred investment, in the access price. Thames' position was that there would be no charge if Albion remained within the agreed balancing mechanism but that if there was a consistent and predictable surplus above that, Thames would be happy to purchase that as a separate supply. Enviro-Logic never took up that offer.

207. According to the Director, the claimed analogy with the gas industry is of little assistance to the determination of the issues in this case. There is no evidence before the Tribunal as to whether or not surplus gas is of benefit to Transco.

208. Finally, Albion's complaints as to the inadequacy of the Director's reasoning ignores the whole of the section 47 procedure which culminated in the letter of 1 April 2004 to

Enviro-Logic. Albion has failed to show how the reasoned decision in that letter was inadequate.

209. Thames submits that even a dominant undertaking cannot be compelled to purchase water it does not require. Thames was always prepared to purchase water from Albion under a separate contract, if it was shown that there was a constant and reliable surplus available: see Thames' letter of 21 September 2001. Thames did not seek to recover balancing costs, but would be entitled to do so if Albion's supplies imposed such costs upon it.

210. Thames supports its intervention with witness statements from Messrs Pittaway, Cresswell, Casey and Shaw. According to this evidence, briefly summarised, Thames remained as supplier of last resort, so it would not be able to free up resources or defer future capital expenditure; Albion's supplies were too small to permit deferral of capital expenditure; there could be balancing costs resulting from Albion's surplus, particularly where the source output was not under Thames' control; not all Thames boreholes run at a steady rate; Thames would not have been able easily to accommodate an additional input of 20Ml/d; Thames would have no control over Albion's customer demand, and would not be able reliably to know what that demand was from day to day; it would be unlikely that the customers' demand would match Albion's output, at all times; and that, according to Thames, the Albion Yard and Bath House boreholes would need considerable expenditure to bring them up to Thames' standards, were those boreholes to be acquired by Thames.

211. Thames accepted that London's ground water level is rising, but Thames needed to choose its sources carefully. According to Thames "Thames accepts that it needs the water, but it cannot just take virtual water. It must pay for real water, consistently and reliably supplied."

212. Thames submits finally that remitting the issue of credit for over-supply to the Director would be pointless now that the provisions of the WA03 will in future set the framework for competition in the water sector.

The Tribunal's analysis

– General

213. The issues as argued before the Tribunal involve in our view two quite different submissions on Albion's part, which need to be disentangled. First, Albion argued that credit should be given for "overs" which according to Albion are likely to arise when water is pumped from the borehole at a constant rate. Albion's argument here is, essentially, that Thames charges for "unders" where for one reason or another Albion is unable to meet customer demand, and should therefore give a "symmetrical" credit for "overs", particularly given that such oversupply has a value to Thames in view of the supply zone deficit in the London area. We describe this as the "overs and unders issue".

214. Secondly, however, Albion argued before the Tribunal that, when calculating the access charge, Thames should give credit for the total amount of the water introduced into the system by Albion, on the grounds that all such water is valuable to Thames, again given the supply zone deficits in the London area. We describe this as the "credit for total supply issue".

215. Thames' position, as we understand it, was that it was prepared to agree a relatively generous supply envelope, within which it would not charge for "unders", but that it would not give credit for "overs" outside the supply envelope on the grounds that: (i) that it was up to Albion to match its supply to the demand profile of its customers; and (ii) in any event this "over supply" was of no value to Thames. Thames, however, was prepared to purchase under a separate contract any constant and reliable surplus water that Albion had available.

– The Credit for Total Supply Issue

216. It is convenient to deal first with the "credit for total supply" issue.

217. Although it is true that echoes of Albion's argument that Thames should give credit for the total supply appear in Enviro-Logic's letters of 21 September and 5 December 2001, in our judgment this aspect was not clearly raised in Albion's complaints during

the section 47 procedure. Consequently, the "credit for total supply" issue is not dealt with by the Director in the letters which comprise the contested decision.

218. Thus, Albion's original complaint of 7 January 2001 raised the "overs and unders" issue, not the issue of "credit for total supply". The subsequent letters of 12 January 2001 (Thames), 24 January 2001 (Enviro-Logic), 8 March 2001 (Thames) and 29 September 2001 (Thames) referred to above, all concerned the "overs and unders" issue. Similarly, the Director's letter of 8 March 2002 rejecting Albion's complaint dealt with the "overs and unders" issue, as did Enviro-Logic's response of 28 March 2002, Mr Jeffery's conversation with Ofwat of 5 April 2002, and Thames' letter of 31 July 2002. Enviro-Logic's formal request to the Director of 6 August 2002 to withdraw or vary his decision of 8 March 2002 similarly deals only with the "overs and unders" issue, as does the Director's summary of his decision of 8 March 2002 published on 31 March 2003. The Director's subsequent letter to Thames of 28 January 2004 and Thames' reply of 13 February 2004 referred only to the "overs and unders" issue, as did the Director's letter to Peninsula Water of 1 April 2004.

219. In *Freeserve (Validity)*, cited above, the Tribunal said at paragraph 116:

> "We accept, however, the Director's basic argument that, in principle, the original complaint sets the framework within which the correctness of the Director's decision is to be judged, taking account of the material that he had or ought reasonably to have obtained. An appeal is not an occasion to launch what is in effect a new complaint and then expect the Director and the Tribunal to deal with the matter on an entirely new basis."

220. In our view that dictum in *Freeserve (Validity)* should be applied here. The issue of "credit for total supply" was not clearly raised before the Director, with the consequence that the Director did not seek Thames' views on the matter, or deal with it in the Decision. While in general the Tribunal is prepared to accord a certain latitude to complainants with few resources and without legal representation, in the specific circumstances of this case in our view it is not appropriate to permit Albion to enlarge the ambit of the complaint made before the Director.

221. In particular, the material Albion has put before us on this aspect of the case is sparse. In view of the potential importance of the issue of credit for new resources, not least for

the purposes of the potential application of the Chapter II prohibition or Article 82 in the context of the licensing regime introduced by the WA03, in any event it seems to us inappropriate to express a view on that issue on the basis of the somewhat sketchy information before us in this case.

– The Overs and Unders Issue

222. As regards "overs and unders" in the present case, in our view it is appropriate to focus on the sufficiency of one of the elements identified at paragraph 114 of *Freeserve (Validity)*, cited above, namely the Director's reasons.

223. As regards the Director's reasons, the Tribunal also said in *Freeserve (Validity)*, cited above, at paragraph 118:

> "The Director's reasons should enable the addressee of the decision to know what the Director in fact did, and enable him to assess whether the decision is well-founded or not, notably with a view to deciding whether to appeal. In addition the Director's reasons should enable the Tribunal to determine whether or not the decision is correct. If essential elements are not set out in the reasons, it is difficult for the parties or the Tribunal to determine with any degree of certainty what the Director took into account, and what principles he applied at the time the decision was taken."

224. We emphasise that in a case such as the present, the Director's reasons do not need to be detailed or lengthy, but they should at least deal briefly with the essential elements of the complaint made: see *Freeserve (Validity)* at paragraphs 119 to 120. In our view, the sufficiency of the Director's reasoning is conveniently judged by considering Albion's request to vary of 6 August 2002, set out at paragraph 127 above, and the Director's response to that request of 1 April 2004, set out at paragraph 138 above.

225. First, however, it is convenient to begin by setting out how the "overs and unders" issue developed by reference to the chronological order of the correspondence.

226. Albion's position from the beginning of 2001 was that "a situation in which [Albion] pay for any short-term shortfall, but lose the benefit of any over provision is unfair, and likely to constitute an abuse of a dominant market position" (Enviro-Logic to Thames,

5 January 2001 in reply to Thames' letter of 21 December 2000). According to Albion, that approach placed a new entrant in a "no win" situation (Enviro-Logic to Director, 24 January 2001). Thames' position, however, was simply that "[Thames] would not reimburse [Albion] for water supplied into the network that is not consumed by Albion's customers" and that "An entrant should not supply water into the network that is not required by its customers" (letters of 21 December 2000, 12 January and 8 March 2001). As we understand it, Thames' position was, in effect, that it was up to Albion to vary the water supplied into the system to match the demands of its customers. Thames, however, was prepared to allow for daily variations in demand within agreed limits. "Overs" and "unders" within the agreed limits would be netted off over a balancing period of at least one month. Thames also proposed a financial reconciliation every six months (Thames' letters of 21 December 2000, 12 January 2001, and 21 September 2001). However, the negotiations between the parties never proceeded to the stage where the details of these mechanisms were settled.

227. Thames also stated in its letter to the Director of 21 September 2001:

> "If ELL has a predictable and consistent surplus of water available we will be happy to discuss with them options to purchase this as a separate negotiation. There is however no value to us from unpredictable, intermittent inputs into a part of our network. Surplus water is likely to be available when least needed, and the hydraulic management of the system is hindered by water being injected into the system when not required. The effect of this will be felt by the customers close to the point of entry."

228. The Director's decision of 8 March 2002 was in these terms:

> "Complaint 4 – Thames intends to charge for under-supply where customers' demands are not met over the balancing period, but will not provide an equivalent credit for over-supply.
>
> There is no evidence to suggest that Thames will get significant benefit from this supply, despite the supply zone deficit. Over-supply in such instances has the associated costs of balancing and buffering. If your new sources provided significant benefit to Thames, then it might be reasonable for Thames to give credit for over-supply. However, there is no information to suggest that this is the case. If a balancing system is required, then it is reasonable that there will be a cost associated with it."

229. At this stage, therefore, the Director's reasoning appears to be based on two points, namely: (i) that there was "no information" to suggest that Albion's "new sources" were a significant benefit to Thames; and (ii) that there were in any event costs associated with "balancing and buffering". "Balancing and buffering", as we understand it, is essentially the process of balancing supply and demand, e.g. by the use of reservoirs for storage or adjusting the rate of pumping.

230. The Director's explanation accompanying the publication on 31 March 2003 of the decision of 8 March 2002 also refers to balancing and buffering costs, which indicate that such costs were at that stage clearly a factor in the Director's reasoning.

231. However, it has not been seriously contended before the Tribunal that there would in fact be any material costs of "balancing and buffering" arising on the facts of this case. Albion's submission that Thames' system is already adapted to cope with wide variations in demand, without requiring e.g. additional reservoir or other storage facilities to deal with the boreholes here in issue, has not been challenged. Thames in its letter of 21 September 2001 stated that it was not asking Albion to provide buffer storage. In its letter of 13 February 2004 Thames also made it clear that it did not seek any contribution from Albion towards balancing and buffering costs. The Director's decision letter of 1 April 2004 does not appear to rely on balancing and buffering costs, and we have no empirical data relating to balancing and buffering costs.

232. In those circumstances in our view the Director's original reliance in his letter of 8 March 2002 on "balancing and buffering" costs as a reason for rejecting Albion's complaint is not a sufficient reason to sustain the Director's decision of 1 April 2004.

233. On 22 March 2002 Enviro-Logic protested against the Director's decision of 8 March 2002, particularly in relation to "overs and unders". By letter of 31 July 2002 to Enviro-Logic, Thames stated that its position "remains as we discussed some time ago". Thames was prepared to balance "overs and unders" within an agreed supply envelope over an agreed balancing period and reconcile these to a net position. As we understand it, Thames' intention was to balance daily variations over a monthly period within a supply envelope. Beyond that, Thames would charge for "unders" but not give

credit for "overs" which were not supplied as a result of a specific need and would for "the majority of the time" be surplus to requirements.

234. On 6 August 2002, Enviro-Logic made a formal request to the Director to withdraw or vary the decision of 8 March 2002 on the "overs and unders issue". The points made by Enviro-Logic in its letter of 6 August 2002, set out in full at paragraph 127 above, were, so far as relevant[8], as follows:

(i) The Director's guidance in the Access Code that charging arrangements relating to overs and unders should be "fair and transparent" required or implied symmetry when calculating the cost and benefit of new resources.

(ii) It was inappropriate for Thames to insist that Albion should match the demand profile of its customers in the particular circumstances. According to Albion:

> "Incremental sources are most efficient and effective used on a continual and steady output basis. A requirement to match the customers' profiles would result in an inefficient design, either by involving significant storage requirements, or by not using all of the available water licensed for abstraction. TWUL itself needs to match customer profiles in aggregate, but will seek to maximise efficiency by pumping at a constant rate wherever possible. Its distribution network and storage reservoirs are designed to assist in this aim. With a constant input rate it is inevitable that overs and unders will occur within a defined balancing period, particularly when seasonal variations occur. I accept that a charge is appropriate to reflect the value of the commodity 'bought' or 'sold' by the network operator to balance the system."

(iii) The lack of reciprocity in the proposed arrangements was not consistent with the treatment of issues of over- and under- provision in the gas and electricity industries.

[8] Albion has not pursued its complaint regarding Thames' refusal to accept partial supplies to a customer, so we do not deal with the issues arising in that regard.

(iv) Thames did get a measurable benefit from the additional source, of either at least 3p/m³, the short run avoidable cost of resources and treatment, or between 22/pm³ and 45p/m³, the long run avoided cost of such resources.

(v) It was not established that there were any costs of "buffering and balancing", contrary to what was suggested in the letter of 8 March 2002.

235. As to (v), the costs of "balancing and buffering", we have already addressed this issue above. We do not need to deal further with the question of "balancing and buffering costs".

236. The result of the Director's reconsideration of his decision of 8 March 2002 is contained in his letter to Peninsula Water of 1 April 2004, written some eighteen months later. In our view the key part of the Director's response was as follows:

> "Enviro-Logic said that it would like to see the evidence behind the statements in Ofwat's letter of 8 March 2002 that there was no evidence to suggest that Thames Water would get a significant benefit from this supply… In its letter dated 21 September 2001 to Ofwat, Thames Water said that:
>
> > 'If ELL has a predictable and consistent surplus of water available we will be happy to discuss options to purchase this as a separate negotiation. There is however no value to us from unpredictable, intermittent inputs into a part of our network. Surplus water is likely to be available when least needed, injected into the system when not required. The effect of this will be felt by the customers close to the point of entry."
>
> Ofwat did not therefore agree with Enviro-Logic that Thames Water should always provide a credit where there is an over-supply."

237. In our view, the main issue before us is whether the reasoning set out in the above paragraph of the Director's letter of 1 April 2004 is a sufficiently reasoned response to Enviro-Logic's request of 6 August 2002 that the Director should withdraw or vary his decision dated 8 March 2002.

238. We note, first, that in the letter of 1 April 2004 the Director seems to have done little more than quote back to Albion what Thames said to the Director in its letter of 21 September 2001, some two and a half years before. However the letter of 21

September 2001 does not deal with the points raised by Enviro-Logic in its letter of 6 August 2002, since the letter of 21 September 2001 was written eleven months earlier. Moreover, the Director appears simply to have accepted the statements made by Thames in the letter of 21 September 2001.

239. As regards the substance of the issue, we have had some difficulty in determining the scale and significance of the disagreement between the principal parties. Thames' letters of 21 September 2001 and 31 July 2002 suggest that daily "overs" and "unders" within an agreed supply envelope would be reconciled and netted off over a balancing period to be agreed, of not less than a month. In addition, the proposed financial reconciliation was to take place every six months. If, as was apparently intended to be the case, Albion was inputting water broadly in line with its customers' demand within a particular month, it might be expected that the net "overs" or "unders" position at the end of that month might be rather small. If the financial reconciliation took place six monthly, on this basis again the "net" overs or unders would be likely to be rather small, at least in normal circumstances.

240. On the other hand, Exhibit JC1 to Mr Cresswell's witness statement on behalf of Thames appears to assume that Albion's supply at a constant rate would automatically generate "overs"[9] (for which, as we understand it, Thames would not pay). However, that document does not indicate what time period is being referred to. Nor does exhibit JC1 show "unders" or indicate how the reconciliation referred to in the correspondence is intended to operate. This lack of clarity has not been helped by Albion itself, which has not produced any worked examples, nor given any indicative figures, of the financial impact on Albion of Thames' proposals.

241. However, Enviro-Logic's letter of 6 August 2002 suggests that what Albion wanted to do was to input water at constant rate, without having to adjust its inputs as between months of lower demand and months of higher demand. To illustrate what it seemed to us Albion was saying, if, for example, the customer was an academic institution, we could imagine that demand would be lower in the vacation months (say July, August, December and April) than in other months. According to Albion, as we understood it, it would be reasonable and efficient for Albion to continue to pump at the same

[9] Shown as "Over Supply" on that diagram

constant rate through the year and for Thames to give credit for "overs" that occurred in these months of lower demand. The essence of the argument was that: (i) that was a reasonable and efficient way for Albion to exploit the boreholes; (ii) such overs had a value to Thames, which had a supply deficit; and (iii) this mechanism imposed no extra buffering or balancing costs on Thames which already had sufficient balancing facilities available.

242. A development of this theme, as we understood it at the hearing, was not only that Albion needed to pump at a constant rate, but that the constant rate in question needed to be geared to the customer's maximum demand, so as to avoid "unders". Again, said Albion, "overs" would inevitably occur, for example in those months when seasonal demand was lower than in other months. Further, submitted Albion, Thames should give credit for such "overs".

243. At this point the Tribunal would wish to make it clear that it would not accept the proposition that a new entrant is in some way entitled to require an incumbent to pay for any amount of water that the new entrant chooses to introduce, irrespective of the particular facts and circumstances, nor should a claim as to "overs and unders" be used as a disguised attempt to achieve any such aim. We deal with the matter on the basis advanced by Albion at the hearing that its intention was to introduce a constant supply "that was broadly in balance with the intended demand of its customers" (Albion skeleton argument, p. 73).

244. However, whatever the precise mechanism of the arrangements, it was not contested on the part of the Director or Thames that, if Albion's input was at a constant rate, net "overs" and net "unders" could occur to a greater or lesser extent. In essence, in his letter of 1 April 2004 the Director defended the position that Thames could charge for the net "unders", but not give credit for the net "overs", on the basis that the "overs" were not of value to Thames because they constituted "unpredictable, intermittent inputs".

245. Paragraph 2.3.5 of the Access Code as then in force states that:

> "Ofwat expects… The method of charging/reimbursement for over- or under-supply by an entrant to be fair and transparent.

…

The costs and benefits of over- and under-supply depend on whether the network is in deficit or surplus, and the amount by which the supply differs from the agreed normal range. Where there is a significant breach of agreed inputs, the company will have to assess whether that was costly (for which it might charge the entrant) or beneficial (where it might reimburse the entrant). In either case, the company must be transparent and fair in how it calculates the value of the cost or benefit."

246. An earlier version of the Access Code went out to consultation in draft in September 2001: see "Access Code Guidance: A consultation paper". Paragraph 2.3.5 of the earlier version stated

> "**Ofwat expects:**
>
> • The Method of charging/reimbursement for over- or under- supply by an entrant to be symmetrical."

247. The Director explained the change of wording from the original draft to the final version of the Access Code in the document "Discussion of Responses" published at the same time as the latter. In relation to paragraph 2.3.5 the Director said notably

> "Our view is that it is important for the entrant and company to communicate and co-operate over balancing. It seems sensible for the parties to agree a range of volumes within which the entrant can vary its inputs without the company or the entrant incurring any extra costs. This range can be reviewed regularly, and if the entrant is consistently outside that range then it would have to adjust its inputs or its customers' demands, or change the agreed range. Where there is a significant breach of agreed inputs, the company will have to assess whether that was costly (for which it might charge the entrant) or beneficial (where it might reimburse the entrant). In either case, the company must be transparent and fair in how it calculates the value of the cost or benefit. Our request for symmetry relates to the method by which this calculation is made. **We have added these points to our guidance.**"

248. In our view these documents make it clear that even in the case of a significant breach of agreed inputs (presumably made in good faith), such a breach does not absolve the undertaker from considering, in a transparent and fair way, whether the breach was costly (for which it might charge the entrant) or beneficial (for which it might reimburse the entrant). Although the Director argues that the reference to "symmetry" was intended to apply to "the method" of charging, it remains the case that under the

Access Code, the system must be operated fairly. In particular, the Access Code indicates that where there is a benefit to the undertaker there may be a reimbursement or credit for an over-supply, even if that supply is outside the agreed inputs. We take the Access Code to mean that, in this respect, the system has to be operated fairly by both parties in good faith.

249. In the present case, the issue raised in Enviro-Logic's letter of 6 August 2002 was primarily whether Albion should be permitted to input at a constant rate, rather than what would happen in the case of a breach of agreed inputs. As regards the matters raised in Enviro-Logic's letter of 6 August 2002, the Director's reasoning is to be found in the following passage of the Director's letter of 1 April 2004:

> "In a letter dated 21 September 2001 to Ofwat, Thames Water said that:
>
> > 'If ELL has a predictable and consistent surplus of water available we will be happy to discuss options to purchase this as a separate negotiation. There is however, no value to us from unpredictable, intermittent inputs into a part of our network. Surplus water is likely to be available when least needed, injected into the system when not required. The effect of this will be felt by the customers close to the point of entry.'
>
> Ofwat did not therefore agree with Enviro-Logic that Thames Water should always provide a credit where there is an over-supply."

250. Against that background, in our view there are several difficulties in the Director's reasoning, as set out in the letter of 1 April 2004.

251. First, the Director's view is apparently very largely based on the allegedly "unpredictable, intermittent inputs into a part of our network" which, according to Thames' letter of 21 September 2001, had no value to it. However, Albion claims that this statement represents a misunderstanding of the facts. Far from being "unpredictable" or "intermittent", Albion's input into the system is intended to be constant and regular, as pointed out in Enviro-Logic's letter of 6 August 2002. The only element that may fluctuate is not Albion's input, but the customers' demand and hence the degree of overs and unders. But, according to Albion, Thames already knows what the customers' demand profile is (since the customers in question are existing

customers of Thames), and has been managing fluctuations in that demand within its existing system without problems.

252. We do not find in the Director's letter of 1 April 2004 any reasoning dealing with Albion's argument that, far from being "unpredictable and intermittent", Albion's input was intended to be predictable and constant, and that fluctuations in the customers' demands were also largely predictable.

253. Secondly, the Director appears, at least implicitly, to reject Albion's view that it would be reasonable and efficient to input at a constant, predictable rate, with the consequence that, according to Albion, overs would inevitably arise from time to time. This was a principal point of complaint by Albion in its letter of 6 August 2002, and the Director does not address it.

254. Thirdly, the Access Code, as in force at the material time, required an assessment to be made of whether any "overs" outside agreed inputs were of benefit to the incumbent, in which case a credit and/or reimbursement should be given. However, the main reason given by the Director in the letter of 1 April 2004 for considering that Thames should not give credit for such overs was that the *inputs* were "unpredictable" and "intermittent", relying on Thames' letter of 21 September 2001. As already explained above, in the letter of 1 April 2004 there is no reasoning directed to this point. In addition, the Director does not deal with Albion's argument based on the Access Code.

255. As to the Director's denial that any "net" overs arising in this case could have a value to Thames, we note that the Director, in a letter to Dr Bryan of 25 October 2001 stated "we agree that new resources, particularly in the Thames area, have a value…". We accept that it may be necessary to distinguish between the value of new "resources", on the one hand, and the value of "over-supplies" on the other. For example, if in the circumstances of a particular case the "over-supplies" impede in some way the management of the supply/demand balance, they may not have a value. But that in our view is to be ascertained by a consideration of the particular facts of the case. We are not persuaded that there was sufficient consideration of the facts in this particular case. In this case, it seems to us, the real issue was not primarily whether the water had a value to Thames, since in certain circumstances it did. In our view, however, we do not

find in the Director's letter of 1 April 2004 any sufficient analysis of why that value should not be reflected in a credit for "overs", as apparently indicated by paragraph 2.3.5 of the Access Code as then in force. That applies especially where the incumbent in question has a potential supply deficit, and there is evidence that additional resources have a benefit to the incumbent.

256. In that regard, Thames' willingness to enter into an agreement to purchase a "constant and reliable surplus" from Albion also suggests to us that additional water supplies as such do have a present value to Thames, for example contributing to the back up storage of water in reservoirs or helping Thames to conserve some of its own resources, and that such value is not just limited to the occasional dry year, as suggested by the Director. There does not seem to be any reason to suppose that this additional water would evaporate from the reservoir before it was needed, as the Director appeared to suggest in argument, otherwise it is not clear why Thames would be prepared to pay for it. Nor do we see any basis, on the facts of this case, for the assertion on behalf of Thames in the course of argument that the water from the boreholes here in question would simply "slop over the side of the reservoir". Indeed, during the hearing, it was accepted that Thames "needs the water" when consistently and reliably supplied.

257. It is difficult for the Tribunal to take into account Albion's submissions regarding the treatment of over/under-supply issues in the gas and electricity industries, since we do not have any hard evidence to go on. Nonetheless there is no indication that the Director had considered whether or not similar circumstances arose in other network industries, and if so whether the solutions adopted there could be relevant to the circumstances of the water industry.

258. In submissions, the Director's principal argument was that Albion's "mistake" was to imagine that any surplus water necessarily had a value to Thames. According to the Director, it all depends on the circumstances. However, the considerations set out above seem to us to show that the Director did not fully or adequately explain, in the Decision, the reasoning which led him to his conclusion in the circumstances of this particular case.

259. The Director and Thames also submitted (in fact this was Thames' principal submission) that Thames had acted reasonably in offering to purchase from Albion a constant reliable surplus of water under a separate negotiation. We have already indicated that this offer suggests to us that water resources of the kind here in question have in fact a present value to Thames.

260. However, Thames' offer, as we understood it, was limited to what is shown on the diagram at exhibit JC1 as "reliable surplus", and thus does not appear to address the "overs" and "unders" issue discussed above. Albion points out that it did not seek or want a bulk supply agreement with Thames, but a common carriage arrangement enabling Albion to supply its own retail customers. In negotiating common carriage with Thames as the network operator, what Albion was seeking was a credit for "overs" to balance any charge for "unders". That in our view is different from a bulk supply agreement. It is not clear to us from the Director's reasons in the Decision why such a bulk supply agreement represented a satisfactory solution to the "overs and unders" issue.

261. The Director further contended that discussions between Thames and Enviro-Logic on overs and unders were "only at an early stage" and that Enviro-Logic had not replied to Thames' letter of 31 July 2002. There is in our view a certain force in this argument. However, in its letter of 6 August 2002 Enviro-Logic made a request to the Director and it was up to the Director to produce a reasoned response. It has not been argued that his response of 1 May 2004 was not an appealable decision. In any event, by the time Enviro-Logic asked the Director to reconsider the "overs and unders" point on 6 August 2002, that issue had already figured in correspondence going back to December 2000. Thames had made clear its refusal to give credit for "overs" in its letters of 21 December 2000, 12 January 2001, 8 March 2001 and 29 September 2001, and that position was accepted by the Director in his letter of 8 March 2002.

262. In our view only two of the various other points made in Thames' evidence call for comment. First, there is emphasis on Albion's customers' demand not being under Thames' "control". However, the customers' demand is not under Thames' "control" while the customers are Thames' customers, but that in itself does not appear to cause Thames difficulties. Secondly, Thames contends that the boreholes in question would

need substantial capital expenditure before becoming operational. The Tribunal's own observation on its site visit confirms that that is very likely to be the case, and Albion has not suggested otherwise. However, the Director has confirmed that his decision did not depend on any alleged lack of intention by Enviro-Logic/Albion to develop the boreholes in question.

263. We add finally that the suggestion made by Thames in its letter of 31 July 2002 that "in water resource terms it would be better to leave the surplus water in the ground" did not figure in the Director's decision, was not developed by Thames in argument and does not appear to us to be relevant to the "overs and unders" issue.

264. In our view, it follows from the foregoing that we should set aside the Decision contained in the letters of 8 March 2002, 1 April 2004, and 11 May 2004 as regards the "overs and unders" issue on grounds of insufficiency of reasoning.

265. However, the Tribunal does not consider that it would be appropriate to remit this matter to the Director on the "overs and unders" issue. The provisions of the WA03 are now in force, and the issue of over and under supply will have to be addressed in that context, subject to the possible application of the Chapter II prohibition and Article 82 of the EC Treaty: see sections 2(6A) and (6B), 2(7), and 66D(10) of the WIA91, as amended by the WA03. Whatever the position may have been at the time of Enviro-Logic's letter to the Director of 6 August 2002, Albion would now, apparently, need a licence to supply water to customers from these boreholes under the WA03, and we are not aware that Albion has such a licence. Nor is it clear that the customers would be eligible customers under the new arrangements. Those considerations, in addition to the capital expenditure necessary to develop the boreholes, and the question whether Pennon would permit Albion to exploit the boreholes, suggests to us that such exploitation is not a sufficiently imminent or practical proposition to justify remitting the matter. In any event, Albion has not provided us with any information enabling us to determine how far the "overs and unders" issue discussed above would have made any material difference to the ultimate decision as to whether these particular boreholes should be developed or not.

D. ALBION'S SUBMISSION REGARDING A PATTERN OF EXCLUSIONARY CONDUCT

266. Finally, Albion submits generally that the fact that no common carriage arrangements have yet come into existence more than five years after the Director first said that the 1998 Act could be infringed by an unreasonable refusal of access, is essentially due to the monopolistic stance taken by incumbent undertakers and the Director's weak regulatory approach. According to Dr Bryan's witness statement of 7 December 2004 the pattern from the 1990s onwards was one of Enviro-Logic offering customers supplies at competitive prices, the incumbent then reducing his price substantially down to a newly introduced tariff approved by the Director, accompanied by a bulk supply price fixed by the Director at the same level as the new retail tariff, thus leaving no margin for a competitor. Specifically in relation to Thames, Dr Bryan alleges a whole series of anti-competitive activities which have, according to Dr Bryan, successfully thwarted Enviro-Logic/Albion's plans to extract up to 20Ml/day from London's groundwater, which would have reduced both the supply deficit and the risk of flooding. The Director's failure to take effective action, particularly by treating various complaints in isolation, has, according to Albion, materially contributed to this highly unsatisfactory position.

267. The Director submits that these allegations are entirely outside the scope of these proceedings. The Director rejects, in any event, Albion's suggestions as to a pattern of exclusionary conduct, and as to the ineffectiveness of the Director's approach.

268. We agree with the Director that these more general matters raised by Albion do not bear directly on the Decision which is in issue in these proceedings. Nonetheless, we note that, despite the efforts of successive governments to promote a degree of competition in the water industry, the Director has not been able to give us a satisfactory explanation as to why competition by common carriage, foreshadowed by several of the Director's guidance letters between 1999 and 2002, has not in fact occurred.

269. The general issue, raised by Albion, that in considering individual complaints (which may be small in themselves, taken in isolation), the Director might run the risk of not fully taking into account a possible pattern of conduct raising wider issues under the

Chapter II prohibition or Article 82, is no doubt a matter that the Director, and the newly constituted Authority which succeeds him, will bear in mind when exercising the relevant statutory powers.

VIII CONCLUSION

270. For the reasons given above, we set aside the Decision contained in the letters of 8 March 2002, 1 April 2004, and 11 May 2004 on the issue of "overs and unders", on grounds of lack of reasoning. We do not remit the matter to the Director.

Christopher Bellamy Antony Lewis John Pickering

Charles Dhanowa
Registrar 31 March 2006