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IN THE COMPETITION
APPEAL TRIBUNAL

Case No 1046/2/4/04

Victoria House,
Bloomsbury Place,
London WC1A 2EB

9th May, 2005

Before:
SIR CHRISTOPHER BELLAMY
(The President)
THE HONOURABLE ANTONY LEWIS
PROFESSOR JOHN PICKERING

Sitting as a Tribunal in England and Wales

BETWEEN:

ALBION WATER

Appellant

supported by

AQUAVITAE (UK) LIMITED

Interveners

and

DIRECTOR GENERAL OF THE OFFICE OF WATER SERVICES

Respondent

supported by

DWR CYMRU CYFYNGEDIG

and

UNITED UTILITIES WATER PLC

Interveners

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HEARING: DAY ONE

APPEARANCES

Mr. Rhodri Thompson QC and Mr John O’Flaherty appeared on behalf of the Appellant.

Mr. Michael O’Reilly (instructed by McKinnells) appeared on behalf of Aquavitae.

Mr. Rupert Anderson QC and Miss Valentina Sloane (instructed by the Director of Legal Services, OFWAT) appeared on behalf of the Respondent.

Mr. Aidan Robertson (instructed by Wilmer Cutler Pickering Hale and Dorr LLP) appeared on behalf of the Intervener Dŵr Cymru.

Mr. Fergus Randolph appeared on behalf of the Intervener United Utilities.

1 THE PRESIDENT: Good morning, Mr. Thompson.

2 MR. THOMPSON: Good morning, Sir.

3 THE PRESIDENT: Unless there are any other matters that arise, we thought we would best perhaps
4 have a word first about the timetable and the order of play for this hearing

5 MR. THOMPSON: Yes. I had a brief word with Mr. Anderson, and I think each of us somewhat
6 cautiously thinks we will be more than half a day but hopefully less than a day. In terms of
7 order of speeches it seemed to us, I think collectively, that the sensible order was for me to
8 open, followed by Aquavitae, then I think the Director and the two Interveners, probably Dwr
9 Cymru and then United, and then with me having a right of reply, unless anything specific
10 came up that required anyone else to say anything else.

11 THE PRESIDENT: That sounds very much what we were thinking too.

12 MR. THOMPSON: So hopefully the claimants or appellants can finish today, plus Aquavitae as
13 Intervener, and give the Director the floor tomorrow, though it partly depends how we get on.
14 It is possible that I will finish earlier.

15 THE PRESIDENT: We would be quite glad to finish by Wednesday, if we can.

16 MR. THOMPSON: On Wednesday?

17 THE PRESIDENT: Yes, on Wednesday.

18 MR. THOMPSON: That looks hopeful.

19 THE PRESIDENT: That looks feasible. Yes?

20 MR. THOMPSON: In terms of bundles, I have now received a list. Unfortunately I got confused
21 and I think in some documents at least our reply bundle is referred to as bundle 3, but I see that
22 it is now bundle 7.

23 THE PRESIDENT: This is our numbering you mean?

24 MR. THOMPSON: Yes.

25 THE PRESIDENT: We will manage, Mr. Thompson, do not worry.

26 MR. THOMPSON: The only other issue by way of preliminary is that I think Aquavitae have an
27 application, and the suggestion is it should be heard just before lunch, but I do not know
28 whether they want to say something about that.

29 THE PRESIDENT: Can I see what Mr. O'Reilly says.

30 MR. O'REILLY: Good morning, Sir. What we actually proposed to do was to invite you
31 immediately before the luncheon recess to convene either at two o'clock or slightly earlier,
32 without the public being present, so that we can make that application.

33 THE PRESIDENT: Very well.

34 MR. O'REILLY: If I can just explain what it is. We wish to put in a witness statement.

1 THE PRESIDENT: Yes. We have seen some recent correspondence I think about what I imagine
2 your application is about.

3 MR. O'REILLY: I imagine it is about the same thing, Sir.

4 THE PRESIDENT: It is probably convenient to do that at one o'clock. Is that convenient to you?

5 MR. O'REILLY: I have spoken to the Director's counsel and to United Utilities counsel and they
6 feel, I think with us, that it may be better to hear this without the public being present.

7 THE PRESIDENT: Yes.

8 MR. O'REILLY: Thank you, Sir.

9 THE PRESIDENT: We will do that at one o'clock, or we might do it at two o'clock, depending on
10 how we are feeling at the time. Two o'clock may be more sensible, yes.

11 MR. THOMPSON: Good morning again. The submissions that I wish to make today fall broadly
12 into eight parts. First of all some introductory remarks in relation to the principal issues of
13 excessive pricing and margin squeeze, and I should say at once that the issues of delay and
14 price discrimination, which are found in the pleadings and in relation to price discrimination in
15 our skeleton argument, I am not proposing to make separate submissions on those. The price
16 discrimination issue is closely linked to the excessive pricing issues and the matter is dealt with
17 in our skeleton.

18 So after an introduction, the second section will be issues which I understand to be
19 common ground between the Director and ourselves which leads to a substantial narrowing of
20 the case, for example, the saga or essential facilities I think is not any longer live; thirdly, to
21 identify the principal points at issue between the Director and Albion and Aquavita; fourthly,
22 the central issue, the Director's analysis of the first access price and, in particular, the issue of
23 non-potable distribution; fifthly, the cross-checks which the Director carried out in this case in
24 his Decision; sixthly, and there we move on to the question of margin squeeze, what I might
25 call the legitimacy of Albion's business model. There is quite a lot of rather aggressive and, in
26 my submission, inappropriate criticism of Albion's business model in the Director's skeleton
27 argument, so I need to address that, I think. Seventhly, we come to the appropriate level of
28 margin if, as we submit, we are in fact a legitimate business entitled to a margin, and then,
29 finally, the question of remedy, and, in my submission, that falls really into four sections.

30 First of all we say it is clear that this Decision cannot stand and must be set aside and
31 we say, secondly, it is clear that on at least three heads there is a case of abuse here. Thirdly,
32 we say that the issue of the quantification of precisely how great the excess price is or what the
33 necessary margin is may well be something which we will not get to the end of in these three
34 days, and so that is a matter that needs to be addressed, and the Tribunal take a view as to the

1 correct approach. Then, fourthly, the question of ----

2 THE PRESIDENT: That, according to you, if we ever got that far, would be something for us rather
3 than something to send back for the parties to ----

4 MR. THOMPSON: The way I put it is that in resolving this vexed issue the Tribunal will have to, as
5 it has done in the past, consider whether or not it has enough material in front of it to determine
6 this question or whether, were it to find that the thing is a bit of a dog's breakfast, but not clear,
7 the matter should be looked at again by the Director, and that I think is something which will
8 emerge during the hearing.

9 Then fourthly there is the issue of interim relief, which obviously does need to be
10 resolved, and I would propose to take that very shortly in opening. Dwr Cymru and the
11 Director have said something about that, but essentially I think that is a matter that can be dealt
12 with at the end, and I think that is the view that the Director has taken in correspondence, that
13 he does not want the issue of interim relief to bog us down at this stage.

14 Sir, if we can now go to my introductory remarks. In my submission, there are two
15 fundamental issues here. First of all, can it be compatible with the Competition Act for an
16 incumbent monopolist in an upstream market to offer no margin at all to a market entrant,
17 seeking to take advantage of a market opportunity on a downstream market for which
18 Parliament has made specific provision, and we say in relation to Dwr Cymru one has to
19 resolve whether that is an abuse, and in relation to the Director one has to resolve whether his
20 policy, which is clearly evidenced in his skeleton of deliberately approving a situation where
21 there is no margin in such cases, whether that policy can conceivably be lawful.

22 The second issue is can it be compatible with the Competition Act for the Director to
23 accept, without any scrutiny, for the regional average costs of bulk distribution of non-potable
24 water are the same as for potable water in circumstances where the contribution claimed for
25 permitting water to flow from an incumbent monopolist's non-potable system is, on the
26 Director's own analysis, some 15 times the operating costs of that system, whereas both Dwr
27 Cymru and the Director accept now that a normal difference between operating costs and total
28 costs would be about five times. So we say first of all, is this an abuse again against Dwr
29 Cymru and secondly, is the Director's position – particularly as set out in paras. 297 to 302 of
30 the Decision – is it defensible?

31 Just going into a little bit more detail on the two issues of margin squeeze and excess
32 pricing by way of introduction, we say that the core issues for margin squeeze are, I think, five
33 fold. First, what is the nature of Albion's business? Secondly, is that business legitimate?
34 Thirdly, does that business include services for which Dwr Cymru currently charges as part of

1 its own price to consumers? Fourthly, is Albion entitled to a margin below Dwr Cymru’s final
2 selling price for the purposes of conducting that business; and fifthly – and this is where one
3 gets to the point of detail – what is the appropriate approach to costs’ allocation for the purpose
4 of calculating a margin? In summary, of course, we say that Albion’s business is legitimate
5 and it is entitled to a margin.

6 The core issues for excessive pricing are, in our submission, was the Director justified
7 in accepting that the bulk distribution costs for non-potable water are the same as for potable
8 water, as evidenced at paras. 300 and 301 of the Decision. Secondly, should the Director have
9 demanded comparative costs’ data of the kind provided by Dwr Cymru in relation to treatment
10 costs, as broadly speaking the new tariff, the second bulk supply price, the ECPR approach,
11 and the costs’ principles in the 2003 Act, were those four cross checks appropriate and
12 sufficient to identify any excessive pricing in relation to treatment and distribution services, in
13 the circumstances of this case, as evidenced by paras. 306 and 317 to 341 of the Decision?
14 Broadly speaking evidenced by para. 294 of the Decision; and thirdly, were the cross checks,
15 used by the Director, we say the Director was not justified to accept what he accepted but he
16 should have demanded comparative costs’ data and the cross checks he used were manifestly
17 and hopelessly inadequate in that they assumed what they sought to prove. So much by way
18 of introduction.

19 Secondly, issues that we understand to be common ground. First, in the reply at
20 para.7 to 16 we set out what we said to be the correct approach to the burden of proof and
21 matters of that kind in an appeal of this kind by reference to the Tribunal’s Judgment in
22 *Freeserve*. We understand that to be essentially common ground and, not surprisingly, that it
23 sets out the Tribunal’s view on the matter, and I do not propose to say anything more about
24 that. Secondly, in relation to market definition, we set out our position in some detail at paras.
25 27 to 36 of our skeleton argument. The Director has not put that in issue, the only point he has
26 raised is a procedural one but, in our submission that is effectively common ground.

27 Thirdly, in relation to dominance, we set out the matter at paras. 37 to 41 of our
28 skeleton argument, and we also referred to standard textbook of Richard Whish. I would just
29 take the Tribunal briefly to that part of our case, because in my submission it is important
30 background, under the heading “Market Power” on p.12 of the skeleton argument. Paragraph
31 41 sets out the considerations that we say are relevant to the market power of Dwr Cymru.
32 First of all it has, and has always had a market share of 100 per cent. There is no actual
33 competition. A sustained market share of 100 per cent. is in normal circumstances the most
34 obvious indicator of dominance, and we refer to rather a comic quotation from Richard Whish

1 in the footnote. There are very substantial barriers to entry. First, the market is a very limited
2 one; it is already fully serviced by the Ashgrove System. Any investment in the competing
3 transport and treatment system to supply Shotton and Corus would be expensive. Such a major
4 investment to compete with an established monopolist would be highly speculative in the
5 absence of a long-term contract with a major customer. There is no evidence that any
6 competing water undertaker is actually intending to undertake the necessary investment in the
7 short to medium term, so there is no imminent competitive threat to Dwr Cymru's monopoly
8 position.

9 Albion itself is not threatening to make and plainly could not justify such an
10 investment. As the Director himself recognises, Albion's licence is terminable on one year's
11 notice so there is a substantial regulatory risk. Equally, the Director identifies no other third
12 party who is a potential new entrant into this small market.

13 So we say that those considerations demonstrate the market power of Dwr Cymru.
14 We also rely on the fact that Shotton is having to subsidise Albion's business as an indicator of
15 market power. We therefore summarise the position, if one turns back to p.9, footnote 13, we
16 refer to another passage of Whish, where he says:

17 "It may be helpful, therefore, to identify a concept over and above dominance, that we
18 might call "super-dominance", where the risks of being found to be acting abusively
19 are correspondingly higher; if a dominant undertaking has a "special" responsibility,
20 a super-dominant has one that is even greater" Given the statutory framework and the
21 current state of the UK water market, it is hard to think of a clearer case of monopoly
22 power where it would behove a regulator to be vigilant against abuse."

23 That has not been challenged by the Director in his skeleton and in my submission that is the
24 correct position. Likewise I do not detect any particular dispute about the correct legal tests for
25 abuse which are set out in detail in our skeleton in relation to excessive pricing at paras.44 to
26 56, and, in particular, the quotation from the *Napp* judgment at para.54. The margin squeeze
27 case law and learning is set out in detail at paras.76 to 83 of our skeleton, and a recent
28 judgment in relation to price discrimination is set out at para.93. Again it appears that the legal
29 tests are common ground and there is no real debate between the parties.

30 The next area which – there has been quite a lot of sound and fury but, in my
31 submission, essentially the correct approach is not in dispute in relation to excessive pricing.
32 First of all, both parties accept that the starting point would normally be a calculation of costs,
33 and the Decision sets out a detailed analysis at paras.250 to 307 of the Decision. Secondly, I do
34 not understand there to be any dispute that it is appropriate to cross-check any result by

1 reference to other comparators, as was done in *Napp* and as appears from the European case
2 law, and the cross-checks that were undertaken appear at paras.306 and 317 to 331 of the
3 Decision. Thirdly, I do not understand there to be a dispute that in this case it is appropriate to
4 have a combination of general and specific costs. As the Tribunal pointed out, the Decision at
5 para.255 recognised the complications that arose in this case. At para.294 the Director looks at
6 specific costs data relevant to non-potable treatment, and at 297 to 302 although he makes no
7 adjustment he does consider the question of whether or not potable and non-potable distribution
8 costs should be different, and, in my submission, that is highly material to this question of
9 de-averaging which appears from time to time in somewhat frenetic terms in the Directors'
10 pleadings and skeleton. In my submission, it is quite clearly common ground that de-averaging
11 is appropriate first of all between bulk and local distribution, and one finds an example of that
12 at para.285 of the Decision, and, secondly, between potable and non-potable costs, and one
13 finds that, for example, at para.294 of the Decision.

14 The sixth area, which at least for the purposes of today's hearing or this week's
15 hearing is common ground, is that the primary focus of this hearing should be on the adequacy
16 of the Decision as taken by the Director, first of all, as a matter of substance, whether the key
17 steps at paras.294 and 300 of the Decision are credible; secondly, as a matter of procedure did
18 the Director investigate the matter properly and, in particular, the question of distribution costs;
19 and, thirdly, the question of remedy, particularly in relation to treatment, whether the Director
20 has taken appropriate steps to remedy the overcharging that he found. As we understand it, just
21 as he says that a zero margin is appropriate on the particular facts of this case because we are
22 not doing anything, he also says that no remedy is appropriate in relation to treatment so that
23 Dwr Cymru is entitled to go on charging 4p. over the odds, notwithstanding the fact that the
24 Director has found that that represents overcharging, so that we are effectively funding the
25 purchase of the water for the benefit of Dwr Cymru. We made that point in our skeleton and
26 there has been no response to it from either the Director or Dwr Cymru.

27 The third area we go on to is the points of dispute between the parties, and to some
28 extent I have addressed this already. The first point that is clearly in dispute is the nature of
29 Albion's business and the legitimacy of its business model, and one finds that scattered
30 throughout the Director's skeleton argument, but, in particular, at para.14 of the skeleton, and it
31 may be worth just turning this up. I think the point is first made at para.11 on p.8. As
32 I understand it, the Director uses the words "brokerage inset" to mean retailer, and he thinks it
33 is something that is not acceptable in the water industry, and he says:

34 "Currently, in the market for the supply of non-potable water to Shotton, as a licensed

1 undertaker Albion is doing nothing more than interposing itself in the supply chain.
2 The same water is going through the same pipes to the same customer as happened
3 before Albion's Inset Appointment, which amounts to a so-called 'brokerage inset'.
4 And then at para.14 – this is an objection which appears in the Decision as well.

5 “In its Skeleton, Albion states that it was ‘*unable to access alternative water sources*’,
6 and therefore devised a common carriage business model. However, rather, it appears
7 that Albion chose not to progress the option of developing a new water source
8 because it thought that other options for seeking a reduction in the Second Bulk
9 Supply Agreement price were more commercially attractive.”

10 As I understand it, in the Director's vocabulary “commercially attractive” is a term of abuse,
11 and that one of the reasons why he does not think this complaint needed to be pursued was that
12 Albion pursued its commercial interest rather than investing in new water resources.

13 Then at para.17 is another item which appears in various places in the skeleton. The
14 Director says:

15 “Although in its Skeleton Albion complains that it is entitled to a margin, in fact it is
16 no more entitled to a margin than someone who interposes himself between the
17 postman and the customer's front door and demands a margin for the service of taking
18 the post from the postman and posting it through the letterbox.”

19 So the Director seems to see the activity that Albion is engaged in as a sort of officious
20 bystander who rather annoyingly interposes himself into a perfectly satisfactory commercial
21 transaction, and that is another reason why no margin should be allowed and the complaint
22 should be regarded unsympathetically. Related to that, it is said that Albion has made no
23 investment and that it is not entitled to a margin, and, as I understand it, that would also be the
24 Director's objection to the points that are made in quite a lot of detail in Aquavita's
25 intervention and the skeleton argument about the realities of this market and what would be
26 required to open the market to retail competition. So that is clearly an important point of
27 dispute between the parties.

28 The second area of important dispute is the acceptability of the Director's basic
29 scrutiny and especially step 6 in relation to distribution at paras.297 to 302 of the Decision,
30 which I am sure the Tribunal will have in mind and which we will come back to in due course.

31 Just by way of a side remark at this stage, I do not know if the Tribunal received a
32 letter of correction from the Director on Friday?

33 THE PRESIDENT: Yes, I think we did.

34 MR. THOMPSON: I am afraid these are slightly jury points but I think I am probably allowed one

1 or two of them, but they are points that rather undermine our confidence in the Director's
2 rigour of investigation given that he has been investigating this matter for almost ten years. On
3 the first page, the last paragraph:

4 "Paragraph 160 of the Defence states that OFWAT conducted a site visit and took
5 photographs of the works, but then it turns out in fact the photographs were provided
6 by Dwr Cymru during the course of the investigation and OFWAT itself did not carry
7 out a site visit other than that of the Tribunal on the 3rd February 2005."

8 So we found that a slightly surprising error for a regulator to make.

9 The second one appears right at the end under the heading "Fourth", and it is a
10 reference to a paragraph in the skeleton argument, para.106.

11 "It states that the potable unit costs appear to be at least 75% lower than those
12 presented in the original 1998 paper justifying the suite of large industrial tariffs."

13 And then it says:

14 "In fact this sentence should read: 'These potable unit costs appear to be around only
15 75% of those presented in the original 1998 paper justifying the suite of large
16 industrial potable tariffs'."

17 There is obviously a typo there which I do not take any issue with, but this is a reference to
18 some calculations made by Dr. Bryan where he sought to come out with a 16p. distribution
19 figure by reference to detailed costs. It is annex 2 of the Albion skeleton. But it is now
20 revealed that apparently a figure of 21p., 25 per cent. higher than 16p., appeared in a 1998
21 paper. We were surprised to learn what is, on its face, quite an interesting and important fact in
22 this letter served on Friday, and it is illustrative, in my submission, of the sort of difficulties
23 that my clients have had in trying to get to the bottom of the costs issues in this case in that
24 really quite material facts appear in dribs and drabs in surprising places.

25 THE PRESIDENT: Just to understand that, Dr. Bryan had been arguing for a 16p. figure.

26 MR. THOMPSON: He had understood that there was a consistency between the potable distribution
27 costs as evidenced by some justifications that Dwr Cymru put forward in 1998 and the
28 Decision. It then appears in a somewhat garbled form at para.106 of the Director's Decision
29 that there was in fact quite a striking inconsistency between the figures, at least on their face. It
30 may be that it can all be sorted out, but it is the sort of thing that raises doubts in the mind of a
31 complainant when it has not been explained at all.

32 The third example: on the second page of the letter there is a reference, under the
33 heading "Skeleton", to para.26.2 of the Defence, and an explanation that is given there in
34 relation to how the costs of supply from United Utilities to Dwr Cymru are calculated, and

1 again, in my submission, somewhat embarrassingly for the Director, he then has to give a
2 different account of how it actually works, and one that is quite material in that it shows that
3 the share of capital costs that Dwr Cymru has to make are limited to the supplies relevant to the
4 Ashgrove system, and this is a point that is made against us in the skeleton argument, and, in
5 my submission, again it is somewhat surprising that the Director has not got its act together
6 somewhat sooner than last Friday.

7 So that is the points of dispute. The first one was the nature of Albion's business, the
8 second one acceptability of the Director's basic scrutiny, and the third one the acceptability of
9 the Director's cross-checks. I summarised them a moment ago. The first one that I have
10 referred to is the ECPR approach whereby essentially all that happens is one takes the retail
11 price, excludes costs that are avoided, and then looks at the remainder. We say that that is a
12 hopeless and irrelevant approach for the purposes of identifying excessive pricing because it
13 simply assumes what it seeks to prove, namely, that whatever is left is acceptable. And so we
14 say that that is no cross-check at all.

15 The same applies to the second bulk supply price, which is essentially the same price
16 as the Director has just investigated, less the resource costs.

17 Thirdly, we say the costs principle is vitiated both by an error of law, for the reasons
18 set out in our Reply, and, as a matter of fact, shares exactly the same defect as the ECPR
19 approach, as indeed I think the Director effectively recognises in the Decision.

20 Then, fourthly, at para.306 there is a passing reference to the new tariff which, as
21 I understand it, was a calculation taken by Dwr Cymru in about 2002, and applied from 2003
22 onwards. Our objection essentially there is that the Director seems to take a rather inconsistent
23 approach. He applies some findings that he reached, or that Dwr Cymru reached, in relation to
24 treatment, at para.294 of the Decision, but he does not seem to take any notice of any
25 differences identified in relation to distribution at paras.297 to 302. So although that might be
26 an acceptable cross-check, it does not seem that it was actually followed through in this case.

27 The fourth area of dispute relates to the validity of Albion's own cross-checks. We
28 say that they are of relevance because we say that they cast doubt on the Decision's figures
29 and, secondly, that they are consistent with the commercial realities both of other bulk supplies
30 and of the margin squeeze, and we say that the comparisons that the Director makes in order to
31 attempt to rebut the reality of the conclusions that Albion reaches are all unfair in that they are
32 effectively all to other retail customers or to other incumbents, such as Anglian or Severn
33 Trent. But what they all share is that they are never parties seeking to enter the water market.
34 We say that this is really a key point to the entire appeal that the Director treats new entrants to

1 the water market as outsiders who should be regarded as equivalent to retail customers. So he
2 compares their prices to retail prices in relation to excess pricing and he refuses to countenance
3 any margin from within the water industry. We say that, in effect, the Director appears to want
4 competition to be financed by customers not by suppliers, and we say that this is a hopelessly
5 misguided approach in the present case and analogies, such as the postman analogy give a
6 strong flavour of the curious approach that the Director takes to the discharge of his statutory
7 functions in this area of the law.

8 The fifth area relates to de-averaging where there does appear to us to be some
9 residual area of dispute between the parties. We say that the Director is inconsistent. In
10 relation to the large industrial tariff for potable users and, indeed, the new tariff, he clearly
11 recognises the legitimacy of the difference between bulk and non-bulk supplies and de
12 averaging for that purpose and that is set out at para. 247 of the Decision and paras. 285 to 6.
13 Moreover, at para 294 of the Decision he clearly recognises the legitimacy of de-averaging
14 between potable and non-potable supplies, and one can see that not only at 294 but also at an
15 earlier stage and indeed Dwr Cymru recognises the legitimacy of de-averaging between
16 potable and non-potable supplies. If one takes the Reply bundle, which I think is bundle 7.
17 There is a tab D at the back, which has a number of interesting documents in it, but here at p.49
18 one finds an answer to a s.26 Notice and an explanation of step 4. Towards the bottom,
19 para.4.1:

20 “Non-potable customers do not enjoy full treatment and so are not charged the full
21 amount for water treatment. Previous submissions to OFWAT have assessed that the
22 cost of non-potable treatment is typically 30 per cent. of the cost of full treatment to
23 potable standard.”

24 And there is a reference to a 1996 document, and its acceptance by OFWAT. It represents all
25 the lesser costs of treating non-potable water, and at 4.2:

26 “Accordingly, the 30 per cent. figure has been applied to the company average cost of
27 water treatment to give a figure of 7.2p per cubic metre.”

28 That also appears in the justification – I can just give the reference, bundle 2, tab 9, p.35 where
29 the same figure appears. Then in the Decision, if one takes that up, it is tab1 of bundle 2. If
30 one turns to p.63 of the Decision, you find at para.246 towards the bottom: “Dwr Cymru set
31 out the methods it had used for calculating the first access price in a letter.”, and then gives
32 further details. 247:

33 “At the time Dwr Cymru offered the first access price it did not have a general tariff
34 for non-potable water upon which it might have based the first access price.

1 However, subsequently Dwr Cymru proposed new large user tariffs for 2003/4 which
2 included volumetric charges for both raw water and partially treated water. We
3 examine, and then approve these under the established annual tariff review and
4 approval process under the Water Industry Act 1991. The new tariff, which would
5 apply to Shotton in 2004/5 if Dwr Cymru were to supply Shotton directly would
6 equate to a unit price of 26.6p.”

7 So that is what the new tariff was, and then as one goes through the Director’s analysis from
8 250 onwards, one finds various references to the approach adopted under the new tariff, and in
9 particular on p.75 you find the approach adopted in relation to treatment costs.

10 “As part of its work on the new tariff Dwr Cymru reviewed its assumption of the split
11 between potable and non-potable treatment costs by examining the treatment costs
12 incurred at eleven treatment works of a comparable size and capacity to the Ashgrove
13 Treatment Works. On the basis that this new work Dwr Cymru considered that non-
14 potable treatment costs should be assumed to be 15.2 per cent. rather than 30 per cent.
15 of potable treatment costs and the new tariff was calculated on this basis.”

16 Then there is an expression of surprise that the figure was not higher, which is interesting.

17 Then there is a sentence starting “However”:

18 “However, although the eleven treatment works considered are still only a sample,
19 this new work clearly indicates that 15.2 per cent. would be a more appropriate figure
20 in this stage 5 of the first access price calculation. We therefore think an appropriate
21 adjustment should be made.”

22 So it is clear that here the Director considers that de-averaging is the correct approach by
23 reference to the actual difference in costs between potable and non-potable treatment.

24 However, at paras. 297 to 302, essentially a green light is given to treating potable and non-
25 potable distribution costs is the same, without any analysis of any underlying figures – one can
26 see that at paras. 300-302. I will come back to this in due course, but we say that that is
27 inconsistent, that having recognised the difference and the need for statistical material to justify
28 the difference, the Director should have required the same in relation to distribution.

29 We actually go further than that because there are some curious features of the
30 Director’s case ----

31 THE PRESIDENT: He is saying that whether it is potable or non-potable when you are transporting
32 it the cost is the same, really.

33 MR. THOMPSON: Yes, he makes what I have called a “jury point” in the past, but it is perhaps an
34 intuitively obvious point that, in itself, while water is flowing down a pipe it does not really

1 matter whether the water is red, green or blue, it will cost the same amount for the water to
2 flow through the pipe.

3 THE PRESIDENT: Yes.

4 MR. THOMPSON: That may be true, but at para.300 there are various cost drivers identified and
5 our case is that he should have looked at whether or not there was a difference in those cost
6 drivers, and we say that when you look there are some quite spectacular differences, which he
7 should have analysed and that he completely failed to do so.

8 PROFESSOR PICKERING: Could I just ask on that, is there a possibility that non-potable maybe
9 more prone to silt in the pipe? Is there a technical difference between potable and non-potable
10 in that respect?

11 MR. THOMPSON: I think informally there could be. I suspect that that might be more the case
12 with raw water as against partially treated water and, indeed, the Tribunal may recall that in
13 our Notice of Appeal there is an analogy drawn between the treatment at Ashgrove and the
14 treatment in a reservoir, where effectively the silt is given time to sink down. Whether there is
15 any particular difference once the initial de-silting has taken place either as at Ashgrove, or in a
16 reservoir I am not sure – I suspect there will be views in this room more expert than mine; I am
17 very happy to take them and share them.

18 There is one final point on the inconsistency in relation to de-averaging. One finds
19 from the Director's skeleton that, on occasion, Albion actually is criticised for not de-
20 averaging and not taking Albion's actual costs and one finds that at para.107 of the Director's
21 skeleton. Here there is criticism being made of Dr. Bryan for estimating that the value of the
22 Ashgrove Pipeline was £2.2 million. I will come back to this, but the way that Dr. Bryan
23 achieved that figure was by dividing the mileage of raw water aqueducts shown in Dwr Cymru
24 asset inventory, by the total MEAV figure given in Dwr Cymru's asset inventory, and then
25 multiplying by 15 if the Tribunal follows me. The way the figure was reached was by looking
26 at the total value of the piping into which the Ashgrove system is included, or classified by
27 Dwr Cymru, dividing by the length of that part of Dwr Cymru's network and multiplying by
28 the length of the Ashgrove main of 15 kms., and that gives a figure of £2.2 million. The
29 Director clearly thinks that is an unacceptable approach, and says:

30 "The risky nature of this calculation is not exposed, but more importantly nor is an
31 explanation offered as to why Albion did not use the actual MEAV figure that they
32 have for the Ashgrove main as set out in the answer to Q14 of the Director's Section
33 26 notice in 2001, and disclosed by the Director, which gave a figure of close to £8
34 million in 1995 prices."

1 Now, we say that this is a curious approach for the Director to take. When the figure is high at
2 Ashgrove he seems to think that de-averaging is rather a good thing, that we ought to do it.
3 When the figure is low there are howls of protest that the world will fall and that consumers
4 will pay too much because we are trying to rely on the actual costs at Ashgrove. We say that
5 this is not an appropriate approach for a Regulator to take.

6 I come now to my fourth area, which is an area of some detail, which I have flagged
7 to some extent already but relates to the Director's analysis of the first access price, an
8 approach that he adopted in the Decision. I have prepared a short note for these purposes
9 which I would like to hand in, which I hope will be helpful. (Document handed to the
10 Tribunal)

11 THE PRESIDENT: Thank you, Mr. Thompson. Do you want us to quickly read this or ----

12 MR. THOMPSON: I think we will just go through it in due course. It is really just an
13 aide-memoire, which I think is slightly clearer than what appears in the Decision. And then
14 paras.4 and following make a quite specific point in relation to the cost drivers for non-potable
15 distribution, which I think needs to be gone through in some detail.

16 First of all, the Dwr Cymru analysis which stood behind the Director's analysis in the
17 Decision is found in bundle 2, tab 9, pp.31 to 40, and you will see that this is a letter dated the
18 20th February 2001, and para.1 says:

19 "The price that we are minded to charge Albion Water for the services requested is
20 23.2p. per metre cubed. This is the 2000 to 2001 price."

21 So that is the basic conclusion.

22 Then appendix 1, starting on p.33, sets out the reasoning adopted by Dwr Cymru in
23 the form of an appendix and various schedules, and if you turn over to Schedule A you will
24 find the conclusions set out in tabular form, and it is really the right-hand two columns, and you
25 will see that the common carriage price, the one we are concerned with, in the right-hand
26 column consists of two figures, 7.2 for treatment, 16 for bulk distribution, whereas the middle
27 column for non-potable large industrial users gives an additional figure of 3.9, that being the
28 figure for the water itself, the resources.

29 Then Schedule B, p.35, on the facing page, you will see the calculation that was
30 followed in relation to non-potable treatment. You start with the average cost of water services
31 at 73.3p., you then split resources and treatment from distribution and reach a split 27.9 to 45.4.
32 You then split again resources and treatment and reach a figure of 3.9 and 24, and then the
33 figure we have seen before, 30 per cent., appears in the next line, so 30 per cent. of 24 is given
34 as the non-potable treatment figure. So that is how you reach the treatment figure. And in

1 relation to bulk distribution, you reach the figure of 16, and that is explained at Schedule G.
2 The figures do not entirely match but the basic approach was to take the average of the top
3 band, which is the band of over – I have forgotten the precise figure, but it is the largest users –
4 1 million cubic metres per year. To take the price that was worked out as appropriate for them,
5 to deduct the water resource and treatment cost identified in Schedule B, that reaches a figure
6 of 16. In fact the figures in Schedule G do not quite align with the figures in Schedule B, but
7 the alignment in B is the one that was followed by the Director, and I do not think we take any
8 point on the inconsistency between Schedule G and Schedule B, which may be explicable;
9 I may have missed it. But that is the gist of it.

10 So we say what is clear is that the approach is simply to allocate what are in fact total
11 average revenues for Dwr Cymru into three sections, resources, treatment and distribution, to
12 exclude resources altogether from the access price, given that this is an access price for
13 treatment and distribution, and to derive non-potable treatment costs as a proportion of potable
14 treatment costs, and one sees that clearly on p.35 of tab 9.

15 The Decision's analysis of the issue of treatment culminates at para.294, which we
16 have looked at briefly, and at the bottom of p.75 of the Decision there is reference to a figure of
17 15.2 per cent. rather than 30 per cent., and Albion sought, as it were, further and better
18 particulars of how this figure had been reached, and by a combination of pleadings, etc. – I do
19 not think there is anything in dispute – it eventually emerged in a letter dated the 24th March
20 that this figure of 15.2 per cent. derived from a short table, which is annexed to our skeleton
21 argument. You will find in our skeleton argument bundle, which I think is bundle 10, at the
22 back of it there is a little file of documents, which is in fact annex 5 to the skeleton, and it is
23 p.10 – they are numbered SA10, and then my copy here, SA11, is rather obliterated, but SA12
24 reappears. If one looks on SA12 you will find that the average figure is indeed 15.2 per cent.,
25 and the Director has explained that this is the table that was used . You will see a number of
26 black lines on SA10 and SA11, and I think if you count them up ----

27 THE PRESIDENT: Those are different undertakers, are they not?

28 MR. THOMPSON: Yes. Some of them are average figures but they represent I think altogether 12
29 individuals, and then the average figures are given in the last two lines on p.SA11. These are in
30 fact individual water treatment works of Dwr Cymru, and our understanding is that they fall
31 into categories which are divided – there are two double lines on p.11. Our understanding is
32 that there are effectively two non-potable works, both of which are on p.11. The non-potable
33 work, which is the third one down on p.SA11 – does one see that? There is a line saying
34 “CCV” and a figure of 1,449 ----

1 THE PRESIDENT: Yes.

2 MR. THOMPSON: That is one of the non-potable works, we think, and the other one is two down,
3 the one with the CCV of 2,354,598. And so the exercise is to compare, first of all, the
4 1,449,000 plant with the nine plants that appear before it, then to compare the one plant with
5 the other that appears in the middle box on SA11, and then finally to work out an average
6 figure based on the combined figures, and it is that average figure that is finally used.

7 THE PRESIDENT: That is a straight arithmetical average, is it, or is it a weighted average or ----

8 MR. THOMPSON: It is a straight arithmetical average of the total figures I believe. It may not be
9 immediately obvious to the Tribunal what this table is, and perhaps I can ----

10 THE PRESIDENT: That is probably a slight understatement!

11 MR. THOMPSON: I will be corrected as to the initials because I cannot remember exactly what the
12 initials are, but, as I understand it, if one takes the very first item, the first works, at the top of
13 p.SA10 you will see a CCV figure of 12,034,428.

14 THE PRESIDENT: Yes.

15 MR. THOMPSON: And, as I understand it, that is the total value of the works as estimated by Dwr
16 Cymru.

17 THE PRESIDENT: What does "M & E" stand for?

18 MR. THOMPSON: CCV, as I understand it, stands for "current cost valuation", and we understand
19 it to be broadly equivalent to MEA, as that appears elsewhere in the papers. In layman's terms,
20 the difference between Civil and M & E is I think the difference between fixed plant and
21 movable plant. It is between civil engineering, as it were, concrete physical assets, and
22 mechanical engineering. So, broadly speaking, what I said is perhaps technically not correct.
23 So, for example, the pumps at Heron Bridge would come under M & E whereas the walls
24 would come under Civil. You will see that the 12 million is allocated 60 per cent. to Civil and
25 40 per cent. to M & E.

26 You will then see in the next column 60 and 20, and I understand that to be that the
27 walls are then divided by 60 so they are effectively depreciated over 60 years whereas the
28 M & E are divided by 20, so they are effectively depreciated over 20 years, the idea being that
29 the walls will last for 60 years whereas the pump may wear out after 20.

30 You then divide by 365 to reach the figure on the right-hand side, the pounds per day,
31 and you then add them up again and get to the figure of £989.13 per day, and in fact that is a
32 purely mathematical relationship. It is just over 12,000 between the CCV figure and the
33 pounds per day figure. You will see that it is consistent if you go through. So, for example, the
34 next one is just over £1,000 per day and the CCV figure is slightly higher. So all you are doing

1 is applying a mathematical formula to the value of the asset and then comparing it to the
2 megalitres per day – first of all, gives an average figure of 23 megalitres per day and then gives
3 a maximum capacity figure of 40, that being presumably the capacity of the asset, and the two
4 figures are then given. That is done for all the nine comparators in the first category, and an
5 average figure appears at the end of that nine, where it says mean average flow and max flow.
6 As I understand it, that is the average cost per megalitre for those plants, and it is simply related
7 to the asset value of the plants. So all they are saying is that it costs that much on average by
8 reference to the asset value of the plants.

9 Then the last line in the first section gives a figure which I think Dr. Bryan suspects is
10 Ashgrove, and that that may be the reason for all these black lines, but that is purely
11 speculation on our part – we do not know – but, anyway, it is a non-potable treatment works
12 operated by Dwr Cymru which has relatively low costs per megalitre of 4.41 on average, and
13 3.97 maximum, which, as you will see, is either 11.5 per cent. or 17.3 per cent. of the average
14 of the other nine plants.

15 There are then two ----

16 THE PRESIDENT: And what you invite us to infer from all that is?

17 MR. THOMPSON: You may think it is a rather tedious exercise, and in some ways it is, but this
18 document is in fact – these three pages – the basis for the 4p. reduction in the tariff which it
19 appears to be common ground between Dwr Cymru and the Director was appropriate, and so
20 what they looked at was the value of the asset, compared it to the flow, and expressed the one
21 as the other, and when they found that the value of the asset was, relatively speaking, only 15.2
22 per cent. of the value of the potable asset, they required Dwr Cymru to reduce their prices
23 accordingly – or they did not actually require them to, but they found that they ought to have
24 done. So it is in fact an important document, in my submission.

25 THE PRESIDENT: Sorry, Mr. Thompson, can you just help me a bit more on this document, if it is
26 important, so that I have got it. We have got a number of plants here, most of which are
27 apparently dealing with potable water – is that right – but two of which are dealing with
28 non-potable?

29 MR. THOMPSON: Yes. If one goes to para.294 of the Decision, and the Director himself has said
30 I think in the rejoinder ----

31 THE PRESIDENT: Costs associated – 11 treatment works, yes.

32 MR. THOMPSON: Of a comparable size and capacity to the Ashgrove treatment works. On the
33 basis of this new work Dwr Cymru considered that non-potable treatment costs should be
34 assumed to be 15.2 per cent. rather than 30 per cent. of potable treatment costs, and the new

1 tariff was calculated on this basis. So this is apparently all there was which formed the basis of
2 this quite important adjustment.

3 I think if one expressed it as a formula you might say, “How much would it cost to
4 recover the depreciated costs of the relevant assets first of all for potable and then for
5 non-potable treatment works based on their average of maximum capacity?” That seems to be
6 the exercise that was done. The two figures were compared, found to be 15.2 per cent., and
7 Dwr Cymru reduced its prices accordingly.

8 THE PRESIDENT: Can I ask you what is probably a rather stupid question which one must ask
9 from time to time in order to expose one’s own inaccuracies. These calculations appear to be
10 based on a mixture of applying the two main elements, the CCV on the one hand and the
11 capacity on the other hand, dividing effectively the one by the other.

12 MR. THOMPSON: Yes. It is partly capacity and partly actual flow. So you average between
13 capacity and average flow.

14 THE PRESIDENT: Yes, and it so happens that the – let me put it round the other way. What I am
15 not quite sure about is why the non-potable plants turn out to have, where we see that the non-
16 potable plants have lower treatment costs because it just seems to be, well a slightly random
17 calculation depending on what the CCV happens to be of the two non-potable plants at the
18 time. Or can we immediately see that from looking at this that because the CCVs are rather
19 lower for the non-potable plants that one can infer that the cost of treatment at the non-potable
20 plants is lower? How do I get to treatment costs from CCV and capacity figures?

21 MR. THOMPSON: Well that might be a very good question, but that is clearly the exercise that was
22 done. Suppose, for the sake of argument, that the third one down on SA 11 is indeed
23 Ashgrove, and I am not saying it is, one looks and one sees its CCV is 1½ million and the
24 maximum capacity is about 30. If you look at the top you will find a treatment works with the
25 capacity which is very comparable, indeed its average usage is about the same, they are both
26 27. But you look at the CCV it is nearly £10 million. It appears that the reasoning is simply
27 the third one down, whatever it is, in inverted commas “Ashgrove” is a crumby old plant worth
28 only £1½ million, whereas the one at the top is a better plant worth nearly £10 million, and that
29 fact is treated as a proxy for average cost. Whether or not Ashgrove actually appears in this
30 list, the Tribunal will have seen Ashgrove for itself and may infer that in general it is not a state
31 of the art unit and it is possible to conceive of a more expensive form of treatment works than
32 Ashgrove, and I think what is being shown here is that on average the non-potable works that
33 Dwr Cymru has are relatively modest sets of works as against the types of works they use for
34 potable treatment – but I do not think it is any more sophisticated than that, although of course

1 the numbers are themselves complicated.

2 THE PRESIDENT: You could perhaps infer that the non-potable plants just happen to be rather old
3 plants, and if there had been a new non-potable plant then one might get a different picture.

4 MR. THOMPSON: I am not sure because these are CCV figures, so they should be not simply
5 representing the crumby old state of the plant, but also the replacement cost of the plant.

6 THE PRESIDENT: Right, so the replacement cost of the plant is likely to be lower for a non-potable
7 plant than for a potable plant?

8 MR. THOMPSON: Yes, I think so.

9 THE PRESIDENT: Although it can be a bit marginal, sometimes if one looks, for example, at the
10 last entry on the page, let us say 11, where you have a CCV of 3.8, and you compare that with
11 the CCV of the other apparently non-potable plant.

12 MR. THOMPSON: I think the other one there is the average, in fact, I think it is simply the
13 arithmetical sum of the third one down 1449, and the fifth one down, 2354 which are the two
14 non-potable plants.

15 THE PRESIDENT: Oh, I see.

16 MR. THOMPSON: So if you add them together I think you get 3803.

17 THE PRESIDENT: I see, right.

18 MR. THOMPSON: And you compare that as against the CCV of the potable and you find a quite
19 significant difference.

20 THE PRESIDENT: I see, so that is a very important difference, yes, I see, I have got that.

21 MR. THOMPSON: But of course the total capacity is greater for the potable and the non-potable, so
22 when you come to the average it is not quite so spectacular. So, for example, the maximum
23 capacity of all the potable works is 402.

24 THE PRESIDENT: Yes.

25 MR. THOMPSON: Whereas the maximum capacity for the two non-potable is 100, so only about
26 a quarter.

27 THE PRESIDENT: Yes, I see.

28 PROFESSOR PICKERING: Mr. Thompson, on SA 11 the percentages, against what you believe to
29 be Ashgrove, of 11.5, I assume that that is 4.41 divided by 38.29? Is that right?

30 MR. THOMPSON: Yes, that is right.

31 PROFESSOR PICKERING: The average flow, which is presumably for the sum of all the previous
32 plants.

33 MR. THOMPSON: But I do not know where 38.29 comes from. I do not know whether it is simply
34 summing-up all of the costs per day by the total capacity.

1 PROFESSOR PICKERING: It is quite important because it seems to have some relationship to the
2 15.2 which is the bottom, bottom line, is it not? But if that is so, and then 3.97 over 22.97, that
3 is about 17 per cent.

4 MR. THOMPSON: Yes.

5 PROFESSOR PICKERING: So that seems to follow from there, but then can you help me to see
6 how we get the 24.8 and 26.9 per cents in that end column further down?

7 MR. THOMPSON: I think that is simply 5.3 over 22.27, and 2.76 over 10.28.

8 PROFESSOR PICKERING: Sorry, where do those denominators come from?

9 MR. THOMPSON: If one looks, there is only one comparator in that class, as I understand it. There
10 are two classes of work.

11 PROFESSOR PICKERING: Right, yes.

12 THE PRESIDENT: What distinguishes these two classes, Mr. Thompson?

13 MR. THOMPSON: Well we are rather at a disadvantage, rather like archaeology in ancient Egypt,
14 trying to work out what the Director is up to, but we surmise they are different asset classes of
15 works, because we do not know which ones they are and we have no date or anything on them.
16 We guessed that they are different categories of works.

17 PROFESSOR PICKERING: That is, of course, quite important, is it not, if what the Director has
18 then done is to add the numbers for those two works that you assume to be non-potable if in
19 fact they are different categories of works. Do you have a view as to whether that summation
20 is legitimate and, if so, whether the 15.2 per cent. that comes out of it has any validity?

21 MR. THOMPSON: I do not know whether I am being fair or unfair to the Director, but my
22 understanding is that he did absolutely nothing except write down the figure 15.2 which Dwr
23 Cymru gave him, there is no critical reasoning applied to this exercise at all, it simply appears
24 as 15.2 just as 30 appeared when Dwr Cymru told him 30 previously. So there is no blame to
25 the Director, but equally no credit to him in that he did not analyse the matter.

26 In terms of de-averaging, you will have seen various submissions made by us,
27 including in our skeleton that Ashgrove is in fact a fairly primitive form of treatment works.
28 Were the Tribunal to see some merit in that submission it may well be that, as it were,
29 Ashgrove were the more appropriate comparator for the purposes of the Director's calculation,
30 which might mean that 11.5 per cent. is actually the right figure.

31 THE PRESIDENT: 15.2 is the average of what and what now? I am getting slightly lost.

32 PROFESSOR PICKERING: It is the weighted average of 11.5 and 24.8 is it not, plus the average of
33 17.3 and 26.9, is it not?

34 MR. THOMPSON: I must say I had simply thought that it was between 14.4 and 16.1, but it may be

1 that there is a more scientific basis for 15.2.

2 PROFESSOR PICKERING: And the 14.4 is what, exactly?

3 MR. THOMPSON: 14.4 is the average capacity of the two non-potable works compared to the
4 average capacity of the potable works. In practice I think it is the figure of 5.04 as expressed is
5 a proportion of 34.93 on the previous page.

6 THE PRESIDENT: Yes, I think it is.

7 MR. THOMPSON: The final averaging exercise is based on the totals of the first line plants in the
8 first box, and the first plant in the second box, compared to the two final plants in each box.
9 But the 15.2 per cent. figure I am not clear exactly on what basis, whether it is simply the
10 arithmetical mean of 14.4 and 16.1, rounded up or down, or whether there is some scientific
11 basis for it.

12 THE PRESIDENT: It is just the arithmetical mean, I think, of 14.4 and 16.1, which would, just as
13 a matter of mental arithmetic, be 15.25.

14 MR. THOMPSON: Yes.

15 THE PRESIDENT: Right.

16 MR. THOMPSON: There are obviously two questions arise from this. First, whether this itself was
17 a very satisfactory basis for the Decision in relation to treatment, but perhaps more
18 importantly, having seen that this approach was adopted by Dwr Cymru in relation to
19 treatment, why did the Director not do some comparable exercise, perhaps exactly the same
20 exercise *mutatis mutandis* for the purposes of distribution?

21 THE PRESIDENT: Yes.

22 MR. THOMPSON: If one then turns to the distribution exercise – we have looked at it in outline
23 already – if one starts with the Reply bundle, tab D, p.24 you should find a letter dated 2nd
24 December 1998 from Dwr Cymru to OFWAT, headed “New Large Industrial Tariff”.

25 “Firstly, can I apologise for not contacting you sooner with our proposals for new
26 large industrial tariff.”

27 Then in the next paragraph the document sets out the structure of our proposed tariff for 1999
28 and beyond. The third paragraph:

29 “We believe that the proposed tariff not only reflects the true price of providing water
30 to our industrial customers, but will also give customers choice. In addition, we have
31 tried to minimise the impact of this tariff change on domestic customers by choosing
32 the most cost-efficient structure.”

33 So in outline what is going on here is at the end of 1998, in fact under pressure from a previous
34 incarnation of Albion Water, various large industrial tariffs were popping up and this is the

1 Dwr Cymru version, and it starts at p.26, and is quite a detailed justification of introducing
2 lower prices for large potable users, and one sees on p.27 a table setting out a number of bands
3 and under 2.5 you will see:

4 “The tariff will only apply to potable water users. The tariff structure for non-potable
5 users already reflects the reduction in price per metre cubed due to lower treatment
6 and distribution costs. However, in the light of the proposed new LIT [large industrial
7 tariff] the current standard non-potable price is under review.”

8 Then the box sets out proposed bands of 0-49 megalitres per year, going up to a maximum of
9 1000 to 5000 megalitres per year, and so that is the broad shape of the tariff structure that was
10 being proposed, so different prices for different categories.

11 If one then turns to p.35, we find something called “Appendix 4” “Allocation of
12 Distribution Costs to Consumption Bands”, and if one looks at the third line “total
13 consumption” you read across and you will see that the 0-50 has much the largest consumption
14 232,000 megalitres, and then the right hand column has the smallest consumption 3,688
15 megalitres, and then the total figure is given. You will see that in the right hand column there
16 were only two customers.

17 THE PRESIDENT: Yes.

18 MR. THOMPSON: You then go down to the bottom of that column, and you see a number of
19 adjustments per metre cubed made, if you look at the top left hand you see “Reductions to
20 standard tariff of 80.13” and then there are a number of reductions made, some of which are
21 based on any A value you will see. Then at the bottom you will see a total reduction of
22 34.032p and a new tariff of 46p with the discounts allocated. So that is, as it were, the
23 cheapest potable water that Dwr Cymru was proposing to sell, which were to the largest
24 potable users and you will see at the top that their consumption band is over 1000 megalitres
25 per year and their main size is 600 mm. You might again wonder why we go into that but that
26 is the starting point for Dwr Cymru calculation of distribution costs. You will see that it is
27 based on their proposed costs to two very large users of potable water.

28 THE PRESIDENT: So broadly speaking, the larger the customer the lower the distribution cost?

29 MR. THOMPSON: Yes, and I think the largest customers were deemed to use the largest pipes.

30 How actually true that was in practice I do not know, but that was the broad approach, or rather
31 to only use the larger pipes, I think everyone would use them but the largest customers were
32 deemed, as one saw at Shotton, that essentially they would get their water in a very big pipe,
33 and should only pay for the costs of those pipes.

34 If one goes to the Decision at para.281, p.72, you will see the first sentence:

1 “As discussed above, in calculating the distribution element ...”

2 And this is step 4, which is the unit costs for bulk water distribution, you will see in 280:

3 “... Dwr Cymru did not start from the distribution figure generated by step 2.”

4 Which is what it did when they went to the new tariff.

5 “Instead it used a different starting point by first calculating the average price it
6 charged for supplying potable water to its large user customers on its large industrial
7 tariff, 45.6p. per metre cubed. This figure was then adjusted to 2001 prices by taking
8 account of inflation plus the water service indicative K factor to give a figure of
9 43.9p. per metre cubed.”

10 So, as I understand it, and I do not think this is in dispute, the starting point for Dwr Cymru’s
11 own calculation of distribution was the adjusted price for those two very large users as adjusted
12 to take account of various factors, including inflation, etc.

13 THE PRESIDENT: So the 0.46 that we see in the document headed “Appendix 4” corresponds to
14 the 45.6?

15 MR. THOMPSON: Yes, and then that migrates to 43.9.

16 THE PRESIDENT: And that is further adjusted to 43.9?

17 MR. THOMPSON: Yes.

18 THE PRESIDENT: Okay, all for potable.

19 MR. THOMPSON: All for potable. And then the explanation is given in rather broad terms in 282.

20 Large users take large volumes of water and since they generally use large pipes cost less to
21 supply than domestic and small non-domestic customers, which also use the smaller diameter
22 local distribution network, and we discovered really quite recently that – I am sorry, I will
23 leave that for a moment.

24 The distinction that is being drawn there may not be entirely obvious, is, as we have
25 seen, between the 600 mm pipes and everything else, so some really quite big pipes are treated
26 for these purposes as the smaller diameter local distribution network.

27 Then at 283:

28 “The figure of 43.9 derived from Dwr Cymru’s large industrial tariff ...”

29 That should say “largest industrial tariff”:

30 “... obviously contained a charge for resources and treatment. Dwr Cymru therefore
31 calculated the unit cost of bulk water distribution on its own by subtracting the unit
32 cost of resources and treatment from step 2, 27.9p., from the average cost of
33 supplying large users ...”

34 THE PRESIDENT: Can we just pause there, and risk complicating things. It slightly depends, does

1 it, on what you mean by a “large user”, because on this approach what they have actually done
2 is take the two largest users.

3 MR. THOMPSON: Yes.

4 THE PRESIDENT: And I think the point you are making is that actually there are quite a number of
5 other users who could legitimately be described as large users, at least as compared with
6 household users, but they are not the two largest.

7 MR. THOMPSON: Yes. I think it partly goes to the question of de-averaging and how strongly
8 opposed anybody really is to de-averaging. If you go down to that level of detail why should
9 you not go down to the last one to see what the actual costs are.

10 THE PRESIDENT: They have not averaged the costs of large users. They have taken the two
11 largest users.

12 MR. THOMPSON: Indeed, but it is still quite a small sample to the form the basis and to say that
13 we should not be allowed to de-average, because the heavens would fall. You have gone down
14 to the last two industrial potable users and that is the starting point for this calculation.

15 It may be worth now just looking briefly at the table we handed in, and indeed
16 comparing it to the table that appears at para.257 of the Decision on p.67. If one looks first of
17 all at para.257 of the Decision there is a box called “Step 1 figure”, which is said to be the unit
18 cost for supplying potable water, 73.3p. That is actually a highly misleading ----

19 THE PRESIDENT: Sorry, Mr. Thompson, I just need to find the table you have handed in. Thank
20 you.

21 MR. THOMPSON: The step 1 figure is said to be the unit cost for supply of potable water, on p.67
22 of the Decision. That is in fact rather misleading in that it is actually the average unit revenue
23 for supply of all water except for the Elan Valley and the water supplied under this contract.
24 I do not think it is actually the potable water.

25 THE PRESIDENT: All water, potable and non-potable?

26 MR. THOMPSON: As I understand it, except excluding Elan Valley and our own contract, as I
27 understand it.

28 There is then a split between resources and treatment, which I think we have already
29 seen, and then a sort of diagonal arrow going across to step 4, so the exercise that was done was
30 to deduct the side box, which has not got a number, which has 43.9p. in it, which is actually the
31 price for supplying to these two largest users, and then they subtracted 27.9 which was the
32 calculated share of total revenues in fact, not costs, for resources and treatment, excluding the
33 largest supplies. And, as I understand it, what concerned the Director was the 43.9p. figure was
34 a figure for potable water, the total cost or total charge, albeit for two very large users, but the

1 figure deducted did not relate either to just potable or non-potable but to everything, and the
2 Director considered that was an unsatisfactory basis for the 16p. figure in step 4.

3 So if one looks at my little table, under (a), "DC's calculations", the first step is
4 average revenues per cubic metre for all water, excluding bulk supplies, 73.3p.

5 THE PRESIDENT: Bulk supplies are you and Elan Valley?

6 MR. THOMPSON: Elan Valley I think. Then there is allocation of 1, 3.9p. to resources, 24 to
7 treatment and 45.4 to distribution, then a potable tariff for largest users of 43.9, and that then
8 led to net distribution revenues for largest should be potable users, 16p., which is simply 43.9
9 minus resource cost plus treatment cost. Then the non-potable treatment revenue was simply
10 30 per cent. of the allocated treatment cost, so 7.2p., and the non-potable distribution was
11 simply assumed to be the same as the potable distribution, so 16p. They were added together
12 and that was 23.2p., so that was the DC approach.

13 If one then turns over the page you find the Director's calculations differed. At step 1
14 the Director saw no reason why the Shotton supplies should themselves be excluded and
15 required them to be included and made various other adjustments, which led to the tariff
16 moving to 71.8p., and I have given the reference there. The allocation was carried out in a
17 slightly different way and led to the figures of 6.3 for resources, 21p. for treatment and 44.5p.
18 for distribution, but at this point the Director's analysis split away from the Dwr Cymru
19 analysis, and one finds that at paras.283 and following. And you see the Director's concern in
20 the third sentence of para.284 where he says:

21 "Dwr Cymru's large industrial tariff relates only to potable water whereas the amount
22 deducted by Dwr Cymru for resources and treatment includes both potable and non-
23 potable supplies. We had concerns about this inconsistency in Dwr Cymru's
24 approach which appears to compromise that approach."

25 So effectively a red light/red cross for the Dwr Cymru approach.

26 Paragraphs 285 and 286 then set out two alternative approaches which the Director
27 thought might be possible, both of which have some relationship I think to the new tariff
28 calculation referred to at para.247. So the Director says:

29 "In contracts, Dwr Cymru's starting point on calculating the distribution element of
30 the new tariff was the unit cost for distribution activities produced by step 2."

31 So that is simply the allocation of total in fact revenues between resources, distribution and
32 treatment.

33 "Dwr Cymru then estimated that bulk supplies accounted for 35% of this figure, with
34 the small diameter local distribution network accounting for the remaining 65%. If

1 hypothetically Dwr Cymru had taken the same approach to calculating the step 4
2 figure for the first access price as they did to the new tariff it would have calculated
3 35% of the distribution figure generated by step 2, and the resulting figure for
4 distribution would have been 15.6p. However, any apparent reduction in the
5 distribution element for an access price calculated in this way might be offset by an
6 increase in the final access price resulting from the removal of certain costs at the
7 beginning of step 1 and their reinsertion at the end of the calculation which means that
8 it would not be appropriate to simply adjust the distribution element of the first access
9 price down to this figure of 15.6p.”

10 That is rather a convoluted piece of reasoning, but, as I understand it, the Director
11 considers and is attracted by using the new tariff approach, but then at the last minute ducks
12 away because he thinks it will lead to complications.

13 The actual reasoning in the Decision is at 286, led in by the word “rather”.

14 “In order to assess whether an adjustment should be made to step 4 in the calculation
15 for the first access price we analysed cost justifications provided by Dwr Cymru for
16 its then new large industrial tariffs in November 1998.”

17 And, as I think I have already mentioned, the figure that seems to have been allowed from the
18 Director’s case seems to have been about 21p., but that does not appear here.

19 “These provided evidence that the distribution costs associated with Dwr Cymru’s
20 bulk supplies equated to approximately 35.5% of Dwr Cymru’s total distribution
21 costs. If the distribution element of the first access price was assumed to be 35.5% of
22 Dwr Cymru’s total distribution costs of 44.5p., as produced by step 2 with our
23 adjustments, the resulting distribution element would be approximately 15.8p. and the
24 16p. distribution element of the first access price advanced by Dwr Cymru represents
25 approximately 36% of Dwr Cymru’s total distribution costs of 44.5p.”

26 So what seems to have actually happened is that the Director looked again at some figures,
27 which I do not think we have, produced by Dwr Cymru in 1998, and worked out the percentage
28 of Dwr Cymru’s total distribution costs in 1998 and used that figure as the correct one.

29 THE PRESIDENT: When this passage talks about bulk supplies what is it talking about? Is it
30 talking about the two largest users or is it talking about Elan Valley and Ashgrove, or what is it
31 talking about?

32 MR. THOMPSON: We had rather thought that – I think it must be relating to the two largest users,
33 as I understand it, because this was a justification relating to potable water in 1998, and we had
34 assumed that when it talked about the small diameter local distribution network that that was a

1 relatively small number of pipes, and that the 65 per cent. must relate to something more than
2 the 600 mm network.

3 But the Director expressly stated the contrary in his rejoinder, which is in bundle 8,
4 and if one turns to p.73 of the rejoinder the Director is taking us to task in relation to our third
5 cross-check exercise, but at the bottom of p.73 you will see three words, “the figure of”, or,
6 rather:

7 “This is an estimate we have made of 9,400 kilometres.”

8 Then the Director says:

9 “That is factually incorrect. This estimate appears to be based on an erroneous
10 assumption that the length of potable trunk mains is 35% of the total potable
11 distribution pipe length.”

12 He then says:

13 “The figure of 35% is the figure used in the Decision as a proportion of total
14 distribution costs that could be apportioned to largest size mains.”

15 So he is asserting that 35 per cent. of total distribution costs relate to the more than 600 mm
16 class of pipe.

17 THE PRESIDENT: Just relating that back to the appendix 4 document, which is annexed to your
18 Reply at p.35, I am just trying to work out how this all hangs together.

19 MR. THOMPSON: Yes, and I can see exactly what your Tribunal may be wondering, as to how on
20 earth 35 per cent. of Dwr Cymru’s total distribution costs could relate to those two customers,
21 but that is a surprising thought. But I do not think that the position is quite as odd as that,
22 although it does seem to us still to be quite odd. The position may be somewhat clearer if one
23 looks at p.32 of that same tab D to the Reply bundle, and you will see in the right-hand column,
24 under the heading “Distribution Mains”, “Main size mm 600.” You will see length, 429 and
25 MEA value 696 million.

26 THE PRESIDENT: Yes.

27 MR. THOMPSON: I do not know if you have got manuscript additions?

28 THE PRESIDENT: Yes, we have.

29 MR. THOMPSON: And you will see that underneath 696 there is an average of £1.6 million per
30 kilometre.

31 THE PRESIDENT: Yes.

32 MR. THOMPSON: And there is a total value of £3,847 million written in on the right-hand side.

33 THE PRESIDENT: Yes.

34 MR. THOMPSON: What there is not is a total length, but I have worked out the total length is

1 26,611 kilometres, so it appears that the length of the 600 mm or bigger pipe network is 429
2 kilometres, but its value is £696 million, and if one works that out as a percentage the
3 percentage of the length represented by the 600 mm network is only 1.6 per cent. of the total,
4 whereas its percentage by value appears to be 18 per cent., 696 over 3847, from which appears
5 that the 600 mm potable network is an exceptionally valuable piece of kit, and when one thinks
6 about it one can see why that might be, because it is, as it were, the central nervous system of
7 the potable distribution network which is carrying everything which goes all the way out to the
8 8,000 kilometres of network out at the far left-hand side.

9 THE PRESIDENT: Yes.

10 MR. THOMPSON: And I think what is being said is that the costs of maintaining that core part of
11 the business are 35 per cent. of the total costs, not that the costs of servicing these two largest
12 users represents 35 per cent. of the business. It is still a very surprising figure in that, compared
13 to the length, 1.6 per cent. of the length accounts for 35 per cent. of the costs, and even in terms
14 of value 18 per cent. of the value accounts for 35 per cent. of the costs, but the Director assures
15 us that is the case and so we have no reason to dispute it. But it is a submission I will come to
16 in a moment but, as a matter of elementary calculation, on that value, £1.6 million per
17 kilometre, the Heron Bridge and the Ashgrove pipeline would be worth £24 million.

18 THE PRESIDENT: The Ashgrove pipeline is?

19 MR. THOMPSON: Fifteen kilometres long. It is 600 mm pipe, so if this were like for like piping
20 then the Ashgrove pipeline would be worth £24 million.

21 THE PRESIDENT: Yes, which is rather higher than the CCV values you showed us.

22 MR. THOMPSON: That is the treatment works, so ----

23 THE PRESIDENT: Not the pipeline.

24 MR. THOMPSON: But the Director I think has pointed out that Dwr Cymru claimed that it was
25 worth 8 million; on our calculations it is worth 2.2 million, and on the Director's own
26 calculations in the appendix to the Decision it appears to be worth about 4.6. So, on any view,
27 it is difficult to say that this is like for like kit.

28 THE PRESIDENT: Let me understand this, Mr. Thompson, because it is quite hard going, some of
29 it. You are saying that whatever the general value allocated under the system to the large size
30 mains of 600 mm, you could not actually allocate that value to the Ashgrove system because it
31 would produce a figure way above anybody's current estimate of the value of that system?

32 MR. THOMPSON: Yes. I will come back to this point, but I make it because we got there.

33 If we go back now to the reasoning in the Decision, para.286 of the Decision is in fact
34 an absolutely core element of the reason, but there is no evidence about what the actual

1 distribution costs associated with Dwr Cymru's bulk supplies were or how this figure is
2 calculated, and that is evidenced by the fact that the Director had to correct this on Friday by
3 explaining that in fact there seemed to be a figure of 21p. in here, although it is not evidenced
4 or explained in any way even now.

5 THE PRESIDENT: Sorry, can you just go over that again. 286, what figures are we talking about,
6 the 16 ----

7 MR. THOMPSON: We do not actually know. We simply have the words here.

8 THE PRESIDENT: There are a number of figures in 286. Just let us be clear what has been
9 corrected and what has happened. We have got 35.5 per cent. is the first bit.

10 MR. THOMPSON: If one looks at the first sentence you will see that there is an analysis, which I do
11 not think we have seen, of cost justification provided by Dwr Cymru for its large industrial
12 tariffs in November 1998. That is the document we have been looking at tab D of the reply.

13 THE PRESIDENT: Yes.

14 MR. THOMPSON: Is Dwr Cymru's document, but I do not think we have seen the Director's
15 analysis of that. But it appears that this provided evidence that distribution costs associated
16 with Dwr Cymru's bulk supplies equated to approximately 35.5 per cent. of Dwr Cymru's total
17 distribution costs.

18 THE PRESIDENT: Right, and we cannot actually derive that 35.5 per cent. figure from the
19 document we have been looking at.

20 MR. THOMPSON: No, I do not think so. Then, having done that calculation on figures which are
21 not entirely clear, and which seem to have been corrected in the letter on Friday, at least our
22 understanding was corrected, that is then used as the basis for coming up with the figure of
23 15.8p. as the correct figure for distribution, and because that is not far off 16p. the Director
24 leaves Dwr Cymru's figure in place even though he completely discounted their methodology.

25 THE PRESIDENT: Right. Now I need to look back at what came in on Friday and see if I can make
26 sense of it. Yes, which are we ----

27 MR. THOMPSON: It is the very end of the letter. It may be that we will need to go to the
28 Director's skeleton to make sense of this, which is – well, I do not know where it is in your
29 papers. Paragraph 106.

30 THE PRESIDENT: Yes.

31 MR. THOMPSON: It is at p.52, and the Director says in the last two sentences:

32 "The Director does not actually recognise the potable unit costs used by Albion Water
33 under paragraph 23 of annex 2 to its skeleton. These potable unit costs appear to be
34 ..."

1 And then there is a typo. It should read:

2 “These potable unit costs appear to be around only 75% of those presented.”

3 So the words “at least” and “lower than” should be deleted and it should read, “potable unit
4 costs appear to be around only 75% of those presented in the original 1998 paper justifying the
5 suite of large industrial potable tariffs.”

6 THE PRESIDENT: Yes.

7 MR. THOMPSON: The figure that is used by Dr. Bryan in his calculation is in fact I think 16.3, and
8 if one does a broad calculation you will find that you get to a figure of about 21.3p. as the
9 potable unit costs. That is a completely new figure to us.

10 THE PRESIDENT: And if we go over to what is referred to as the original 1998 paper, which is
11 presumably the document annexed to your Reply – or maybe it is some other document, I do
12 not know.

13 MR. THOMPSON: Yes, that is right.

14 THE PRESIDENT: Can we make sense of the 21p figure from the 1998 document?

15 MR. THOMPSON: There may be a way of doing it ----

16 THE PRESIDENT: But you have not managed to do so yet.

17 MR. THOMPSON: I have not managed it; given the correction and the timetable it has not been
18 particularly easy to do it. It may be that there is an explanation in these papers, but our
19 suspicion is that there is a different document which sets out all these calculations that we have
20 not seen. I think Dr. Bryan is saying that he is able now to derive this figure, whether they are
21 figures that are in the public domain or in our possession before I do not know, but it is
22 possible, apparently, to derive it but I do not think it comes from that paper in itself.

23 THE PRESIDENT: I see, yes.

24 MR. THOMPSON: That, of course, is at the level of potable distribution costs, and this was the
25 basis for the Director’s finding that the potable distribution costs could be accepted in his view
26 as 15.8p or in any event, 16p. But the financially crucial part of the Decision appears at 297 to
27 302. Step 6:

28 “In step 6 Dwr Cymru estimated the unit cost of non-potable bulk water distribution is
29 assumed for the cost of transporting non-potable water in bulk was the same as the
30 cost of transporting potable water, Dwr Cymru therefore concluded that the unit cost
31 of non-potable bulk water distribution [the step 6 figure] is the same as that for
32 potable water. Albion Water argued that Dwr Cymru had pooled the low costs
33 associated with non-potable bulk transport with the much higher cost associated with
34 bulk potable transport in order to manufacture an artificially high access price.”

1 Then there is the recording of a meeting, and then the Director's conclusions are at 300 to 302.

2 "The main cost drivers for transporting water through pipes are linked to the size
3 (diameter) and the smoothness of the pipe, required flow rate, distance, direction and
4 change in altitude between the points at which the water enters and leaves the pipe.
5 These costs drivers are largely independent of the quality of the water being
6 transported. In practice the difference in physical characteristics, density and
7 viscosity, of partially treated non-potable water and potable water would be minimal
8 in so far as they could directly affect the cost of water distribution. It does not
9 therefore appear that the cost of transporting a given volume of water is fundamentally
10 affected by whether the water is potable or non-potable. We do not therefore believe
11 that Dwr Cymru is unreasonable to assume that the cost of transporting non-potable
12 water in bulk was the same as the cost of transporting potable water."

13 Then there is a question about the rags which I do not think we need to go into here.

14 In crude terms it is obviously true that just letting the water flow through the pipe it
15 does not matter what quality of water there is. But in our submission this is a very inadequate
16 analysis of whether or not the cost drivers identified in 300 were actually the same. Indeed,
17 there is no analysis at all. Merely saying that it does not cost any more to let blue water flow
18 through a pipe than red water is not a satisfactory analysis of whether the cost drivers for
19 potable and non-potable bulk distribution are the same. We say that this is just an absolutely
20 hopeless piece of analysis and cannot stand.

21 THE PRESIDENT: So what should he have done, according to you?

22 MR. THOMPSON: If you now look at the note that we have handed in, we have done our best to
23 look at the principal cost drivers identified at para.300 and, in particular, the value and the
24 maintenance or renewal costs of the bulk potable network as against the non-potable network.
25 Secondly, we have looked at the required flow rate as it appears in the most recent pleadings of
26 the Director, because you will see the required flow rate as being one of the factors to be taken
27 into account in assessing the cost drivers for transporting water. Maybe we should take that
28 first because that is an easy ----

29 MR. ANDERSON: Can I just ask my learned friend whether this is an analysis of one of his existing
30 five methodologies, or it is a sixth methodology that is new material, because that will help in
31 cross-referencing?

32 MR. THOMPSON: It is not new material, it is material that appears in the pleadings and is fully
33 referenced.

34 THE PRESIDENT: It is a new analysis, or it is a new working of existing figures to bring out what

1 you say is a difference between the cost drivers for potable and non-potable respectively, albeit
2 it is not quite being put like this so far in the existing pleadings and skeleton? Is that fair?

3 MR. THOMPSON: It is a response to the Director who says this case should be about the quality of
4 this Decision and its analysis of costs and, in particular, in relation to the specific issue of the
5 costs of distribution which clearly, in financial terms is the absolute core of the case.

6 THE PRESIDENT: Well maybe we can track it down later over the adjournment, but Mr.
7 Anderson's question really is what paragraph of which pleading or skeleton argument is this a
8 further development of?

9 MR. THOMPSON: It essentially arises from the debate that has been going on which is still not
10 entirely refined, which we have touched on already about the cost per kilometre, where we
11 have had to try and work out what the actual – rather extraordinarily even at this stage, there is
12 some uncertainty about whether we are talking about the 600 mm pipes or 300 mm pipes, and
13 we have therefore gone into the whole question of how much these different pipes are worth in
14 order to try and understand the pleadings that the Director has put in, including the annexes to
15 his rejoinder, and indeed in his skeleton argument.

16 THE PRESIDENT: Yes. Let us go on for the time being. Do you want us just to read this to
17 ourselves, because it is quite dense?

18 MR. THOMPSON: Yes, it would probably be a good idea.

19 THE PRESIDENT: (After a pause) So on this calculation, Mr. Thompson, very broadly speaking,
20 and I may not have completely mastered the detail, you are saying on various bases that the
21 MEA valuation of the potable mains is higher than the non-potable mains, that the
22 infrastructure renewal expenditure is less for the non-potable than for the potable, and that the
23 rate of flow through the potable is higher than through the non-potable?

24 MR. THOMPSON: Indeed, all of which the principal cost driver is identified.

25 THE PRESIDENT: All of which goes to suggest that the costs for the non-potable are less than for
26 the potable?

27 MR. THOMPSON: Indeed.

28 THE PRESIDENT: So you say.

29 MR. THOMPSON: The reason why this has come up is partly the Director has said this is what the
30 case should be about, so let us look and see if we make the case about that what it tells us.
31 Secondly, he has taken us to task for failing to take account of the specific figures put forward
32 by Dwr Cymru in relation to Ashgrove, and so *inter alia* we have looked at them as well, and
33 we have also looked at the approach that was adopted in para.294 of the Decision, as against
34 the approach adopted at 301, and on any view it seems to us that there is a very striking

1 discrepancy between the degree of rigor exhibited at 294, even if that is not ideal and the
2 approach at 301, which is essentially no reason at all.

3 THE PRESIDENT: But has this point about the main cost drivers being the same been taken up to
4 now in the pleadings? I will need to be reminded.

5 MR. THOMPSON: I think not in those terms, but it certainly has been an issue between the parties
6 going back to 2002 about whether or not potable – in fact it is the core issue that has always
7 been between the parties as to whether bulk distribution of potable and non-potable water are
8 to be essentially equated, and this is the Director’s reason.

9 THE PRESIDENT: Yes.

10 MR. THOMPSON: Indeed, para.298 of the Decision summarises the point that Albion Water has
11 always made. Dr. Bryan points out that in the detailed annex to our Notice of Appeal we have
12 accepted that as long as the cost drivers are the same that is a reasonable approach, but that
13 OFWAT has completely failed to show that they are the same, and all we have done here, for
14 the purposes of this hearing is gone through the evidence in some detail and sought to prove
15 the contrary.

16 THE PRESIDENT: Yes, thank you. There is some comparison, and I am not sure whether it is
17 relevant or not, in **this** document, between “Bulk distribution mains” and what are called “Raw
18 water aqueducts”. Is that a relevant ----

19 MR. THOMPSON: You may recall in the Notice of Appeal there is quite a prominent argument that
20 the relevant comparison for the purposes of the Ashgrove system is the raw water aqueduct,
21 because of the quality of the pipe, and the fact that it was originally intended to supply water to
22 a water treatment works.

23 THE PRESIDENT: And – forgive me if I have mis-remembered it – the slight amount of treatment
24 the water gets immediately it comes out of the river.

25 MR. THOMPSON: Well but the basic point in relation to distribution is that this is water pumped by
26 Mr. Randolph’s clients off a hill and then allowed to flow down a pipe from a treatment works.

27 THE PRESIDENT: So it might just as well be an aqueduct as a pipe?

28 MR. THOMPSON: Yes, it is really a matter of where the treatment works is located.

29 THE PRESIDENT: I do not know quite what a “raw water aqueduct” is, but I imagine it is
30 something that is not enclosed as a pipe is enclosed.

31 MR. THOMPSON: No, I do not think that is right, I think it is a very similar sort of pipe.

32 THE PRESIDENT: It is a very similar sort of thing.

33 MR. THOMPSON: But if the treatment works at Ashgrove were like Brecon, located at the end of
34 the pipe rather than the middle, then this would be a raw water aqueduct. What makes all the

1 difference is because Ashgrove is at the top of the hill rather than the bottom, at least the length
2 between Ashgrove and Sea land is treated as non-potable pipe and the Director accepts that this
3 should be treated therefore as identical in its qualities to the core of the potable distribution
4 network, which comprises similarly large pipes. We say that is a completely bogus
5 comparison. These are in reality just pipes equivalent to a raw water aqueduct, which are
6 valued at a much lower rate.

7 THE PRESIDENT: Yes. In terms of normal 600 mm distribution pipes, or 300 mm distribution
8 pipes, will the water normally be pumped through or is it going to be transported by gravity as
9 in this particular case, or perhaps it is a mixture of the two, I do not know – and maybe it does
10 not matter?

11 MR. THOMPSON: In terms of the flow rates which the Director gives it would suggest that the
12 potable system is under a good deal more pressure than the non-potable, whether that is as a
13 result of pumping I do not know, but it would appear to involve some pumping.

14 THE PRESIDENT: Yes.

15 MR. THOMPSON: I think it is largely a matter of gravity, probably. If you had a pipe that was
16 vertically downhill you would not need to pump it.

17 THE PRESIDENT: Yes.

18 MR. THOMPSON: In terms of the raw water aqueduct question, another reason why it has emerged
19 in the form it has relates to a document produced by the Director on 24th March, which is the
20 asset inventory of Dwr Cymru and that appears again in the SA tab at the end of our skeleton
21 argument. If you turn through it is in fact pages SA 13 to 15. If you look at p.13, table C11,
22 part C3, the Tribunal will see under Group 1 “Water resources” a category of pipe being called
23 “raw water aqueducts”. If you go across under the column “Asset stock total” you will see a
24 figure of 696.65 and that is in fact kilometres. As I understand it it is not contested that
25 Ashgrove appears under that heading for the purposes of this classification.

26 THE PRESIDENT: So it is classified under “Raw water aqueducts” according to you, but not, for
27 example, under Group 5 water mains?

28 MR. THOMPSON: No, you will see there is potable mains, which reads across and there is a broad
29 comparison. If you see “Asset stock bank 4” that will be the 600 mm mains. They seem to
30 have got either slightly longer or shorter; there is 439 580 I think, and then a total kilometre-
31 age of 27,050.

32 THE PRESIDENT: Yes.

33 MR. THOMPSON: That is the total potable main. Then there is zero under “Other - nominal bore”.
34 As we understand it, it is common ground that, in practice, Ashgrove is classified by Dwr

1 Cymru as a raw water aqueduct for these purposes.

2 THE PRESIDENT: Yes.

3 MR. THOMPSON: Then when one looks two pages on you see the valuations. The raw water
4 aqueducts are valued at £102 million in the second line down, under “Gross NEA”.

5 THE PRESIDENT: Sorry, you are on page?

6 MR. THOMPSON: 15.

7 THE PRESIDENT: Yes.

8 MR. THOMPSON: And so that is the valuation of the raw water aqueducts. So we have divided the
9 value by the kilometre-age and reached a figure of some £700,000 per km and if you multiply
10 that by 15 you get a value of about £2.2 million for the Ashgrove pipe.

11 THE PRESIDENT: This is what – depreciated asset value, or replacement value, or?

12 MR. THOMPSON: It is effectively replacement value.

13 THE PRESIDENT: Replacement value?

14 MR. THOMPSON: Yes. The way it works is explained by the Director in the annex to the
15 Decision, that in relation to pipes, they are not depreciated, they are treated as being infinite in
16 time, but the proxy for depreciation is a renewals charge.

17 THE PRESIDENT: Then you have taken presumably the gross MEA figure for Group 5 water
18 mains, potable mains, multiplied that by the kilometre-age and got a rather higher figure?

19 MR. THOMPSON: Well we have not actually done that because we do not have the specific figure
20 for that part of the system, you have only the global figure. What we have done is used the
21 figure that appeared in the 1998 papers that we looked at.

22 THE PRESIDENT: Right.

23 MR. THOMPSON: Where you may recall there was a £1.6 million per km figure. That was Dwr
24 Cymru justification in 1998. I am sure the Tribunal has the flavour. There are many ways to
25 skin this particular cat and we have tried to skin it in a fair way, but no doubt the Director will
26 say ----

27 THE PRESIDENT: However, you cannot fairly say that the cost of non-potable distribution is the
28 same as potable distribution?

29 MR. THOMPSON: That is the bottom line. We say that the figures are quite ... in that respect,
30 including the Director’s own figures.

31 THE PRESIDENT: Does that come to a natural break, Mr. Thompson?

32 MR. THOMPSON: We could certainly stop there if you wanted to deal with this other matter, or if
33 you wanted to have lunch?

34 THE PRESIDENT: I think what we would like to do is just see what all this other matter is about

1 and then either take a decision or hear it more fully after lunch. So, ladies and gentlemen, we
2 will suspend the public hearing of the Tribunal now until 2 o'clock, so if members of the
3 public or those who have no other interest in this particular application would kindly leave the
4 room, we propose to go into camera for a short while to hear a confidential matter.
5

6 (For In Camera hearing see separate transcript)
7

8 THE PRESIDENT: Mr. Thompson, while we are waiting, perhaps I could just say to you, and for
9 the benefit of anybody else that is interested, if we have notice in good time when it comes to
10 handing in documents like the calculations you have been kind enough to hand in this morning,
11 we are able to organise a screen so the document can be put up on a screen so that everybody
12 can see it, because it is sometimes difficult for those that have not got the document in front of
13 them to know what on earth it is we are talking about when we are dealing with complicated
14 issues of that kind, and indeed, more generally, we can put things on screen so that everybody
15 can see them if there is an application to do so in sufficient time for us to get the technology
16 organised.

17 MR. THOMPSON: I am grateful. Does the document have to be presented in a particular form or
18 just on ordinary A4.

19 THE PRESIDENT: Somebody would have to liaise with the Registrar and our technicians, but
20 I think if it is on somebody's computer it can simply be plugged into the system and displayed.

21 MR. THOMPSON: Right, I am grateful for that.

22 Just for the Tribunal's note, just to conclude the section that we were dealing with
23 before lunch, the reference to the issue of the cost drivers in the original notice of appeal
24 documentation is paras.85 to 87 of the detailed document at tab 2 of bundle 2, p.14 of that, and,
25 in particular, para.86, where there is a reference to:

26 "As long as all other costs drivers are the same and for OFWAT's conclusion to be
27 correct, it would have to show that the cost drivers for transportation of a unit of
28 potable water were the same as for the transportation of non-potable water."

29 And obviously there has been a certain amount of, dare I say it, water under the bridge since
30 then in terms of additional documentation and, in particular, the material that was annexed to
31 the Director's letter of the 25th March, which forms the basis for most of the submissions that
32 were made by me this morning.

33 THE PRESIDENT: Yes.

34 MR. THOMPSON: If we now move on to my fifth heading, that is cross-checking, and I think it is

1 clear from the case law and, in particular, from the ruling of this Tribunal in *Napp*, that cross-
2 checking is an appropriate way to try and get a handle on excessive pricing, and the cross-
3 checks that the Director carries out are at para.306, and then 317 to 331 of the Decision.
4 Paragraph 306 relates to the second access price and also the new tariff, which is the tariff
5 referred to and explained at para.247 of the Decision, and there is a reference to the second
6 access price consisting of treatment costs of 3.31 and distribution costs of 14.43, and then a
7 reference to some other administrative and associated costs, and then the Director makes clear
8 that he has not considered whether the second access price itself might amount to an abuse of a
9 dominant position by Dwr Cymru. Then the more general comparators are at paras.317 to 331
10 where he refers to the official component pricing rule, the costs principle and the second bulk
11 supply agreement.

12 In relation to the new tariff, I think the Tribunal already has my submission, but in
13 relation to treatment there was some looking at the underlying figures generated for the
14 purposes of the new tariff. There does not seem to have been any comparative exercise carried
15 out in relation to distribution, and we complained about the inconsistency in that respect.

16 In relation to the second bulk supply agreement and the ECPR analysis, we say that it
17 is plainly a circular exercise, that all that is done is that the resource cost is excluded for the
18 purposes of ECPR, and so it does not really give any independent hold on whether or not the
19 treatment and distribution costs are excessive, and indeed we note, and it is a point I have made
20 already, there is no exclusion by the Director even of the treatment cost, which he found
21 himself to be excessive, at para.294 of the Decision. If that 4p. overcharge had been excluded
22 then it is obvious, by a matter of logic, that the ECPR figure would have been 4p. lower than it
23 actually was.

24 Another matter which, in passing, we consider to be inappropriate is the reliance
25 placed, at paras.320 to 323, on a NERA report which was plainly commissioned by an
26 incumbent water supplier and, with all due respect to NERA, who are clearly eminent
27 consultants, in our submission it is hardly very telling evidence in favour of the objective facts
28 of the matter to rely on a report commissioned by one of the incumbent water suppliers, and, in
29 particular, when the conclusion might be described as somewhat self-serving in that it
30 concludes that ECPR should be the favoured methodology for setting access charges in the
31 England and Wales water industry in a pro-competitive manner, but also says at 321 that ECPR
32 is more likely to lead to access prices that reflect the need to cover total costs or likely to avoid
33 inefficient entry.

34 Also at 323 the Director himself concludes that:

1 “Access price calculated under an ECPR approach may be perceived as being more
2 favourable to undertakers for prices derived from other approaches including some
3 alternative retail minus approaches. This is because ECPR allows the undertaker to
4 produce prices that fully compensated for the net losses that would incur when
5 providing a common carriage or wholesale distribution services, as compared with
6 continued to supply the final customer itself.”

7 In my submission, all that is saying is that for understandable reasons, incumbent water
8 suppliers rather like ECPR. In my submission that is of very little weight in deciding what the
9 right approach should be in a case of this kind.

10 If we now turn to the question of the costs principle. This appears to be another area
11 where the Director has been somewhat erratic in his approach. In his skeleton argument for the
12 purposes of this hearing his position now is that the costs’ principle is essentially irrelevant and
13 one finds that at para.48 of the skeleton. At the start of 48 he says: “There is no need for the
14 Tribunal to have regard to Aquavitae’s statement of intervention”, and then at the end of that
15 paragraph it says: “Albion shares the view of the Director that the interpretation of the costs’
16 principle is irrelevant.” So that obviously implies that the Director himself takes that view, and
17 it refers to para.52 of our Reply. This can be contrasted with the rejoinder which is at bundle
18 8, para.49, p.26 of the rejoinder, where he says:

19 “The Director would like to take this opportunity to correct a misunderstanding on the
20 part of the Appellant which might have arisen as a result of comments made by the
21 Director’s counsel at the case management conference on 2nd June 2004. It is quite
22 clear from the Decision the Director did have regard to both the ECPR and the costs’
23 principle in assessing the first access price as well as the methodology adopted by
24 Dwr Cymru. To the extent that the Director’s counsel’s comments implied that the
25 ECPR costs’ principle approach was somehow of little relevance or of subsidiary
26 importance to the Director’s analysis of Dwr Cymru methodology they were incorrect,
27 and the Director apologises for any confusion caused. The role and importance of the
28 ECPR costs’ principle approach remains as set out in the Decision.”

29 So at the time of the rejoinder the Director took the view that the costs’ principle was relevant
30 but in his skeleton he refers to a remark made at para.52 of our Reply and agrees with it. If one
31 just looks briefly at what that says, that is bundle 7, tab 1.

32 THE PRESIDENT: Yes.

33 MR. THOMPSON: We say that the construction of s.66E is not strictly relevant to the outcome of
34 this appeal. I should clarify what our position is even though we are slightly uncertain what

1 the Director's position is. Our position is that s.66E was not in force and therefore is not
2 strictly relevant to the outcome of the Appeal, that is correct. But, on the other hand, for the
3 reason that the Director himself gave in his rejoinder, he in fact did refer to the costs' principle
4 and rely on it and, indeed, he set out the relevant provision in the Decision. In my submission
5 if, as appears to have been the case, he relied on the costs principle, it is appropriate to see first
6 of all whether he made an error of law in construing what it means; and secondly, whether he
7 made an error of fact in applying the legislation as he understood it to be. We say that both
8 those situations are the situation that prevails. First, he made an error of law; and secondly, he
9 made the same defect as to the facts as he did in relation to the second bulk supply agreement
10 and ECPR.

11 That requires us to look briefly at 66E itself. It is in fact in the authorities' bundle,
12 bundle 3, tab 20. It is the third authorities' bundle, tab 20.

13 THE PRESIDENT: Yes.

14 MR. THOMPSON: You will appreciate that the Parliamentary tradition is these A, B and C are
15 actually new sections so s.66A then B, C, D and E. E, starts on p.14. You will see that:

16 "The costs principle referred to in subsection (3) of section 66D above is that the
17 charges payable by a licensed water supplier to a water undertaker, under the
18 agreement or determination mentioned in that subsection, shall enable the undertaker
19 to recover from the supplier –

20 (a) any expenses reasonably incurred in performing any duty under sections
21 66A to 66C above in accordance with that agreement for determination; and

22 (b) the appropriate amount in respect of qualifying expenses and a reasonable
23 return on that amount,

24 to the extent that those sums exceed any financial benefits which the undertaker
25 receives as a result of the supplier supplying water to the premises of relevant
26 customers."

27 Then there is a definition of "qualifying expenses". It means expenses:

28 "... (whether of a capital nature or otherwise) that the water undertaker has reasonably
29 incurred or will reasonably incur in carrying out its functions".

30 Then there is a further definition of the "appropriate amount" as:

31 "... the amount which the water undertaker

32 (a) reasonably expected to recover from relevant customers; but

33 (b) is unable to recover from those customers as a result of their premises being
34 supplied with water by the licensed water supplier."

1 Then there is a provision about avoidance of costs saying that:

2 “Nothing in subsection (3) above shall enable a water undertaker to recover any
3 amount –

4 (a) to the extent that any expenses can be reduced or avoided; or

5 (b) to the extent that any amount is recoverable in some other way”

6 And this is what is called “Arrow costs”. Our basic submission, which is set out in the Reply
7 is that the Director’s interpretation of 66E as a form of retail minus principle, whereby the key
8 role is the appropriate amount, which he equates to the retail price is plainly wrong. The
9 reason we say that is that it gives no meaning whatsoever to s.66E(1)(a) and simply jumps to
10 66E(1)(b) and treats that as the only relevant figure. We say that the clear meaning of this is
11 that 66E(1)(a) relates to the costs relating to that agreement or determination as it says,
12 whereas 66E(1)(b) relates to the performance to the water undertaker’s functions as defined in
13 66E(2). So I have thought of various ways in which to express this and it seems to me that an
14 analogy which may be helpful to the Tribunal is the analogy which is well known from
15 Community law between the costs incurred by a utility company in the discharge of its
16 universal service obligations and its ordinary commercial costs. If one looks at it from that
17 point of view, 66E(1)(a) relates to the actual costs relating to the actual agreement, whereas the
18 appropriate amount relates to the general costs as defined in 66E(2), the costs relating to the
19 activities of the water undertaker in relation to its functions – so its general functions rather
20 than in relation to that particular contract.

21 THE PRESIDENT: Can I just remind myself how this section, or series of sections works? Section
22 66E(1)(a) refers us back to 66A to 66C ...

23 MR. THOMPSON: Yes, that is three different types of water supply – wholesale water supply by
24 primary water undertaker is at p.1.

25 THE PRESIDENT: Yes.

26 MR. THOMPSON: Then 66A(1)(a), it applies where:

27 “(a) licensed water supplier requests its primary water undertaker to provide it with a
28 supply of water for the purpose of supplying water to the premises of its customers in
29 accordance with the retail authorisation; and

30 (b) the premises are in the area of the undertaker.”

31 So that is the first type of contract. The second one starts at p.4, 66B, “The introduction of
32 water into a water undertaker’s supply system.” 66C starts at p.8 “Wholesale water supply by
33 a secondary water undertaker”, so there are three different types of contract, as I understand it.
34 Then 66D lays out general provisions relating to these three different types of contract. Then

1 66D(3) says:

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

6 So it is a mechanism for setting out the right price. We say that it is a costs’ principle as it says
7 it is. As I understand it the Director’s position is that it is a retail minus principle, which is not
8 what it says it is and which we say makes a nonsense of the statutory work.

9 THE PRESIDENT: So can you just take us through how this would work in our particular case, if it
10 would work in our particular case? Supposing we were under this regime, Albion would be a
11 licensed water supplier, would it?

12 MR. THOMPSON: Yes.

13 THE PRESIDENT: It would apply to Welsh Water for a wholesale water supply, is that what we are
14 talking about, or are we talking about something different?

15 MR. THOMPSON: I am sorry, Sir. I think it would be 66B, “Introduction of water into a water
16 undertaker’s supply system”.

17 THE PRESIDENT: Yes.

18 MR. THOMPSON: Because we are here considering the possibility we buy the water from United
19 Utilities at Heron Bridge, they pump it into the pipe and we then need to get agreement that we
20 can push it through the Ashgrove system.

21 THE PRESIDENT: Yes. So there are various obligations to connect up the system and so forth.

22 MR. THOMPSON: Yes.

23 THE PRESIDENT: And on your approach to this section, supposing that was the application and
24 then OFWAT was asked for a determination ----

25 MR. THOMPSON: Well 66E(1)(a) would require OFWAT to work out what the expenses
26 reasonably incurred in allowing this water to flow through the pipe were. So, as it were, the
27 actual costs of that including of course costs of capital, so that would be 66E(1)(a).

28 THE PRESIDENT: And that does what? That looks at the actual costs of running Ashgrove and the
29 pipeline and all the rest of it?

30 MR. THOMPSON: Yes, it would be whatever – like any other commercial contract. You would say
31 “Well this costs us so much, so that is what you have to pay”, and that would be the first thing
32 they would be entitled to recover their actual costs including operation costs, fixed costs and
33 costs of capital. So an entirely conventional contract.

34 THE PRESIDENT: Yes.

1 MR. THOMPSON: But in addition to that they would be entitled to a reasonable contribution to the
2 amounts that they incur in carrying out their functions, such as providing water for fire
3 engines, or hospitals or old ladies.

4 THE PRESIDENT: And what does that mean exactly, a sort of general contribution to overheads
5 type ----

6 MR. THOMPSON: Yes, the universal service obligations. I suspect that from a past life you at
7 least, Sir, will have seen cases in Luxembourg about whether or not, for example, something is
8 a state aid because it compensates a utility for having a universal service obligation in relation
9 to the postal service, for example, or, to take another example, whether something is an abusive
10 price when it includes an element for the universal service obligation. In fact there are two
11 cases in the authorities which illustrate the point, relating to the German utilities in the postal
12 and telecom sector. They are at tabs 11 and 14 I think of the second bundle of authorities.

13 THE PRESIDENT: I just want to check how this – before we get into that, just see how this works.
14 66E(1)(a) are expenses reasonably incurred, etc., etc., so you say that is the actual cost of
15 putting the water through the pipes.

16 MR. THOMPSON: Yes.

17 THE PRESIDENT: Maintenance and capital and all the rest of it. Then they are allowed an
18 appropriate amount in respect of qualifying expenses, plus a reasonable return. The appropriate
19 amount of qualifying expenses, then it defines qualifying expenses which the water undertaker
20 has reasonably incurred or will reasonably incur, and then it defines the appropriate amount as
21 the amount which the water undertaker reasonably expected to recover from relevant
22 customers, which in this case would be presumably Shotton, but is unable to recover from those
23 customers as a result of their premises being supplied with water by the licensed water supplier.
24 So how does that work? What expenses would qualify as qualifying expenses in our scenario?

25 MR. THOMPSON: They would be the amount required to cover the discharge of the water
26 undertaker's functions, so something independent of the actual contract.

27 THE PRESIDENT: Yes.

28 PROFESSOR PICKERING: Mr. Thompson, you are tying 66E(2) just to 66(1)(b), and certainly
29 those are the two places in which the term “qualifying expenses” arises, but does not 66(1)(b)
30 imply also a reasonable return on the expenses incurred under 66(1)(a)?

31 MR. THOMPSON: As I understand it, 66E(1)(a) and b) are quite distinct, and it is perhaps slightly
32 unhappy that there is the contrast between a reasonable return in (a) and (b), but I do not think
33 that that amount could include the amount recoverable in (a) because the word “amount” does
34 not appear there. So, as I understand it, it is the appropriate amount in respect of qualifying

1 expenses and a reasonable return on that amount, i.e. on the appropriate amount rather than any
2 return on the 66E(1)(a) expenses.

3 PROFESSOR PICKERING: So you are not allowed to make any return on the costs that you incur
4 in supplying under 66(1)(a) on your argument.

5 MR. THOMPSON: I think you would have to include costs of capital under 66E(1)(a).

6 PROFESSOR PICKERING: But that is not necessarily the full return. Depending upon how you do
7 your calculations, the return to the business might actually not just be the remuneration of the
8 cost of capital, might it?

9 MR. THOMPSON: I think it depends what approach one takes to the capital.

10 PROFESSOR PICKERING: Yes, it does. We are agreed on that. I wonder whether in fact the
11 drafting is helpfully clear on this, and if I remember rightly I think that some of the figures that
12 we have seen in this case, including those this morning, actually do make provision for a return
13 on operating expenses, because the effect of that is to lump in the return with costs so that costs
14 plus the return is the same as the price that is being charged, and that seems to me to be the
15 identity in this approach, between costs and the retail price, and then maybe one takes off the
16 arrow price in terms of assessing the costs of supplying somebody who is intermediating.

17 I am sorry if I am now making it even more obscure.

18 MR. THOMPSON: As I understand it, the arrow price – s.66E(4), whichever one calls it – only
19 applies to the qualifying amount.

20 PROFESSOR PICKERING: That is right, that is the retail minus part.

21 MR. THOMPSON: Without getting into whether it is retail minus or not ----

22 PROFESSOR PICKERING: Well, that is what is understood.

23 MR. THOMPSON: As I would put it, it makes perfect sense that if the universal service obligation
24 cost can be recovered by another route then it should not be recovered from the other party to
25 his contract. On the other hand, you do not need to exclude from 66E(1)(a) because those are
26 merely the direct costs of that actual contract, so there is not going to be any question of any
27 arrow costs for 66E(1)(a). The basic objection we have to the Director's construction is that he
28 lumps everything together and does not seem to leave any room for 66E(1)(a). That seems to
29 be an extra cost which does not make any sense. You seem to be able to recover that expense
30 in addition to the qualifying expenses, which seem to us to be a retail plus if anything. You are
31 entitled to the resale price as the appropriate amount, and you are also entitled to the expenses
32 incurred in performing the contract, and that seems to us to make a nonsense of the whole
33 thing.

34 PROFESSOR PICKERING: Well, maybe the Director will be able to comment on this exchange in

1 due course.

2 MR. THOMPSON: Yes.

3 PROFESSOR PICKERING: Thank you.

4 THE PRESIDENT: I am sorry, I am still a bit lost on this section, Mr. Thompson, and can I have
5 another go at it.

6 MR. THOMPSON: Certainly, Sir.

7 THE PRESIDENT: Would it be wholly off net, as it were, to imagine that 66E(1)(a) is referring to
8 some calculation of the actual expenses incurred in performing the actual contract and that the
9 appropriate amount under 66E(1)(b) is some kind of way of recovering general overhead costs
10 incurred by the water undertaker that might broadly equate to the standing charge or something
11 of that kind that he would have charged to the customer who has switched away now to the
12 other supplier but he cannot now recover from that customer because the customer is being
13 supplied by somebody else.

14 MR. THOMPSON: I have no problem with that as a possibility. Whether the standing charge in all
15 cases corresponds to that element or whether it is not a somewhat random allocation or not
16 random but not necessarily corresponding to that particular distinction, I do not know and
17 I would not have sufficient expertise in the industry to know whether the standing charge is
18 intended to reflect, as it were, universal service obligations or whether it is simply a fixed cost
19 and there is a trade off between the fixed cost and the volumetric charge. But if that were the
20 case then I would have no quarrel with that, but I am not sure that that is the way that the
21 standing charge is actually calculated.

22 THE PRESIDENT: Right. Then in relation to the so-called arrow costs, which I think are perhaps
23 66E(4)(b), can you think of any examples in which those costs could be recoverable in some
24 other way other than from other customers?

25 MR. THOMPSON: What I do not know is whether customers – there are some obscurities in this
26 wording, whether other customers means existing customers or whether, for example, you can
27 obtain a new customer or possibly enter into another exchange, for example, with another water
28 undertaker, whether that would count as something other than your customers. In one sense,
29 given this is a commercial business, the likelihood is that it will be in some shape or form a
30 customer. But I suppose if one got a Government grant to compensate you for loss of custom
31 them I suppose that would also be in some other way subject to the State Aids Rules I guess.
32 I do not know what exactly was in the mind of the legislator on that issue. It may be the
33 Director ----

34 THE PRESIDENT: No doubt the Director can enlighten us in due course.

1 MR. THOMPSON: Yes.

2 THE PRESIDENT: Just so that I can be clear, so that everybody can come back and shoot me down
3 later on if necessary, the way at the moment, as a matter of first impression, s.66E seems to me
4 to operate is with the idea that what you can recover are the expenses that are in some way
5 directly related to performing the particular duty that you have got to perform, in this case
6 arising where the water is introduced into the system, and, secondly, in some way a
7 contribution to your general expenses of maintaining the system as a whole, which you can no
8 longer recover from your customer; but on the basis that every customer has to contribute
9 something to the general system, the appropriate amount is supposed to be a sum that makes
10 that contribution. That may have completely muddied the water, but that is my attempt to
11 explain what I think we are talking about.

12 MR. THOMPSON: Yes, and I may have misunderstood what you intended to say, but it sounded not
13 unlike what I was attempting to submit.

14 THE PRESIDENT: Yes, I think that is right. We will no doubt get into more detail in a moment
15 when we get to the Director.

16 MR. THOMPSON: The other point in relation to the legal question is, I suspect ----

17 THE PRESIDENT: So if that is right, Mr. Thompson, where has he gone wrong exactly, or if you
18 are right where has he gone wrong?

19 MR. THOMPSON: He treats the brave new world of the 2003 amendments as introducing, as
20 I understand it, effectively ECPR as a statutory requirement so that the qualifying amount is the
21 total retail price and the only deductions that are appropriate are the financial benefits referred
22 to at the end of 66E(1) and the so-called arrow costs in 66E(4). So he, as I understand it,
23 regards the costs principle as a statutory enshrinement of the ECPR principles, and we find that
24 a surprising outcome because it would, as we understand it, entrench the margin squeeze and
25 excessive pricing issues, of which we complain, as effectively immune from challenge by
26 persons such as ourselves, and I say that because, as I understand it – well, it is exemplified by
27 the analysis in this Decision that unless you can prove some form of ECPR type saving then
28 you cannot either complain of excessive pricing or assert an entitlement to a margin.

29 THE PRESIDENT: So just to see how that works, you say the Director starts with the retail price
30 which he considers presumably to be the equivalent to or a proxy for (a) and (b) set out in
31 66E(1), you knock off from that the financial benefits, i.e. costs avoided, that is to say, “I no
32 longer have to deliver to 25,000 retail customers”, or, “I no longer have to have a billing
33 operation” or something, “and so that is a saving I’ve made” – that is the sort of financial
34 benefit that is talking about – less any so far unidentified arrow costs that you can recover in

1 some other way.

2 MR. THOMPSON: Yes. I am not sure that the first is entirely – I think the financial benefit might
3 have to be a bit more direct than that. I suspect that, for example, the Corus Lagoons might be
4 deemed to be a financial benefit, and obviously if you paid them £500 then that would be a
5 direct financial benefit. But I am not sure that a ----

6 THE PRESIDENT: Yes, benefit is not a particularly apt word for saving cost, is it?

7 MR. THOMPSON: No.

8 THE PRESIDENT: It would just be a benefit that the undertaker receives as a result of the supplier
9 supplying water to the premises of relevant customers. What does that mean? What benefits
10 are we talking about?

11 MR. THOMPSON: I had taken it that the present case, as in other respects, is like a sort of
12 laboratory example, that the Corus Lagoons would have been treated as an appropriate form of
13 benefit. That is certainly how the Director treated that in the past. Admittedly it is not
14 particularly easy to see that as a financial benefit. But leaving that on one side, what exactly
15 financial benefit means, I think that the Director essentially just leaps to 66E(3) and assumes
16 that the appropriate amount, being the amount that it was reasonably expected to recover from
17 relevant customers, is the retail price, and that of course if somebody else is acting as the
18 retailer then the undertaker can no longer recover the retail price from the customers, so he
19 simply treats the appropriate amount as the retail price, as I understand it.

20 THE PRESIDENT: But on that argument, and I am not saying whether or not that is his argument or
21 not, the undertaker would always be able to recover more than the existing retail price because
22 he is entitled not only to the appropriate amount under (1)(b), i.e. the retail price, but on top of
23 that the expenses he has incurred under (1)(a).

24 MR. THOMPSON: Indeed, and that is why really we have always said that this was a nonsense.
25 But I do not think it can take it any further because those are my submissions.

26 THE PRESIDENT: No, I am just understanding your submission at the moment; yes, I see. It is the
27 first time we have really confronted this section in any dialogue.

28 MR. THOMPSON: The other point that we make and, Mr. President, you will obviously be familiar
29 with this, but for the sake of the Tribunal as a whole, there is what might be called a *Pepper v.*
30 *Hart* question, and what that means is that if there is some obscurity in legislation, and there is
31 a limited amount of case law, that in some circumstances one can look at Parliamentary
32 materials to try and work out what on earth it means, and the Director has, without referring to
33 the case or the case law, launched into the Parliamentary materials at some length, both in the
34 Decision and in annex 2 to the Defence, and again in the skeleton. We say that this is not a

1 *Pepper v. Hart* case for two reasons: (1) we say that the statutory wording can be construed on
2 its face, and is rather technical wording anyway and it is not very appropriate to look at the
3 objective of Parliament.

4 Secondly, and perhaps more importantly we say that the material that is relied on is
5 quite inappropriate, in particular as reference to opposition MP's constructions of the
6 legislation which we say is quite inappropriate to look at, and is in itself not conclusive. That
7 is one of the factors that is required before Parliamentary materials are looked at and we say it
8 is highly inconclusive and one can take that, for example, the passage quoted in the OFWAT
9 skeleton argument at para.29 on p.16. The first bullet point:

10 "It is important to recognise too that assets still had to be paid for in the water industry and the
11 undertakers have to recover costs. Our approach is a means to achieve a balance in the unique
12 situation that applies to water which has universal service obligations. In my submission that
13 is at least as consistent with my construction as with the Director's. Indeed, in my submission
14 universal service obligations is a term of art and familiar from Community law and the natural
15 construction is that the additional amount, the qualifying amount is intended to cover universal
16 service obligations, and nothing to do with the retail price. Likewise, we do not want to
17 encourage people to compete who do not take a fair share of the infrastructure costs, because
18 that would mean that there were more costs on existing customers who do not benefit from the
19 competition, as reflected in new s.66C, and then just a very vague statement that:

20 "This would force the undertaker to try and recover the loss return from other
21 customers not benefiting from the competition. One of the negative aspects of
22 competition. We do not want prices to increase for consumers as a result of
23 competition."

24 In my submission this sort of vague material is not at all useful in trying to construe technical
25 legislation.

26 THE PRESIDENT: Yes.

27 MR. THOMPSON: That is our submission on the law. We say that there was an error of law in
28 construing the costs' principle under 66E, and then we say that the same error of fact that arose
29 in relation to ECPR arises here again. The Director's application of the costs' principle at
30 para.330 and 331 of the Decision omits any real scrutiny of whether there is excess pricing
31 here, either in relation to treatment or in relation to distribution. So we say that all the
32 comparators relied on by the Director in the Decision are thoroughly inconclusive and, in
33 addition, there is an error of law there.

34 The other comparison that the Director draws is between the price charged to Albion

1 and the price charged to other purchasers. I think I can make a brief and general submission
2 here. We say that the Director's examples are all retail buyers and the examples that we rely
3 on of wholesale sales are much lower. We do not accept that the correct comparison is
4 between ourselves and a retail purchaser, and we would submit that the more appropriate
5 comparator, as reflected in the Tribunal's questions to the parties, are the large scale
6 commercial purchases such as the Elan Valley sale and the supply by United Utilities to Dwr
7 Cymru where we say that that does give you the flavour of the sort of prices that are
8 appropriate, as it were, on the inside for the water industry rather than on the outside to retail
9 buyers purchasing water from incumbent water suppliers.

10 The second aspect of the cross-checking exercise is, of course, Albion's own attempt
11 to carry out cross-checks, as appeared in the Notices of Appeal and as is sort of battled out
12 between the parties in the pleadings. In my submission for present purposes this is a somewhat
13 of a dark pit to try and get to the bottom of in this hearing, and that for the purposes of
14 establishing the correct principles rather than the precise figures we think that it is not going to
15 be profitable to try and get to the bottom of the detailed comparisons and battle of the statistics
16 that has gone on in the pleadings.

17 Obviously that might be said to be a "cop-out" on my part, but in that respect one has
18 to bear in mind the position of Albion at the end of a 10 year campaign to establish itself as a
19 real competitor in the water market. The lack of confidence that Albion has in the Director's
20 stance and, as we would say, is evidenced in the approach and tone of the Director's skeleton
21 argument the endless prevarication and delay that there has been in resolving this matter has
22 led Albion, understandably to be anxious, to obtain as much assistance as possible from the
23 Tribunal and, for that purpose, to bring as precise information as it can to bear on this case.
24 We say that the Director, and Dwr Cymru have both been extremely unclear in their approach
25 and that Albion has had great difficulty in obtaining robust and consistent information. There
26 is, in fact, a great deal of expertise in this client, but it is obviously only as good as the material
27 which it has available, which it has no entitlement otherwise than from public records, to
28 receive. We maintain the position as set out in our reply as our best effort to date to provide
29 independent checks on the Director's approach. However, we agree with the Director that for
30 present purposes the primary focus should be on the correct approach as a matter of principle,
31 on the adequacy of the Director's analysis in his Decision, and the adequacy of his procedures
32 as evidenced by his Decision and, in particular, in relation to the non-potable costs of
33 distribution, which I have commented on in some detail this morning.

34 We reserve the right to comment further on the specific issues raised by the Director

1 or, indeed, to answer any questions which the Tribunal may have on specific issues. But other
2 than that I would not propose to go into the detail of the statistics on this issue at this stage.

3 MR. ANDERSON: If I could just say in reply to that, it is not going to be entirely satisfactory if my
4 learned friend intends to reserve new submissions to reply, if that is what he means by that.

5 THE PRESIDENT: Mr. Thompson, I think as I have understood it, you have made a certain case in
6 your written pleadings and documents and so forth, and for the purposes of these oral
7 submissions you are not proposing to elaborate on it. But if somebody comes back to it then
8 you will reserve the right to deal with any points that are made?

9 MR. THOMPSON: Yes, we have devoted a great deal of effort to putting our case out in writing.
10 We see that the Director is not persuaded. There is an enormous amount of complexity, even
11 in relation to the three page document in relation to treatment. It took sometime to get to the
12 bottom of it. If we were attempting to do a detailed analysis of any one of the methodologies
13 I suspect that each would warrant a day's argument, and we do not think that that is going to be
14 the best way to use the time, given the fundamental points of principle which need to be
15 resolved in this industry in which this case, for better or worse, appears to be the occasion to
16 resolve them.

17 THE PRESIDENT: Yes.

18 MR. THOMPSON: My next area of submission relates to Albion's business and what the business
19 is and indeed, whether it is a legitimate business. The first submission we make is that Albion
20 seeks to be a full function water company as can be seen from the Thames' case with which the
21 Tribunal is concerned, where we have sought to be a water resource company actually taking
22 water out of the ground and also in relation to the original plans for Shotton where Albion hope
23 not only to obtain a source of water but to actually pipe the water to the Shotton Paper plant,
24 and to undertake whatever necessary treatment for that purpose. But the present case does not
25 relate to a full function water appointment for resources, treatment and transport but to a part
26 of that business, namely, purchase from United Utilities, and then the obtaining of treatment
27 and transport costs from Dwr Cymru, and then retail from Albion to Shotton Paper. So in
28 essence what we have here is a retail function, a water consultancy function and a brokerage
29 function, all of which we submit are entirely legitimate.

30 Looking first at the retail function, we accept that it is a very simple, probably the
31 most simple retail function that you could imagine, given that you have one client, one pipe,
32 one source, but in principle that is itself a legitimate economic activity, and the reality of it can
33 be seen from the contract between Albion and Shotton, which is in the papers at bundle 2, tab
34 12. The contract starts at p. 49. You will see that it is an agreement between Shotton and

1 Albion dated 19th March 1999. It may be appropriate in this regard to consider the Director's
2 analogy of the officious person who stands on your doorstep, grabs letters off you, throws it
3 through the letterbox and then demands money from the postman for the benefit. Here you
4 have a commercial contract between Shotton Paper and Albion Water, dated March 1999. If
5 you turn through you will find on pages 4 and 5, first of all under clause 5, consideration and
6 payment, dealing with Shotton's obligations to pay for the water to Albion, monthly invoices,
7 etc. Then under 6 "Obligations of the customer" in relation to the water supply, so Shotton's
8 obligations, and then under para.7, the obligations of Albion Water.

9 "7.1 Albion water is a water undertaker licensed by OFWAT. It has legal obligations
10 and responsibilities under the Water Industry Act 1991. Its responsibilities include
11 those imposed by the statutory system of economic regulation and are administered in
12 England and Wales, and subject to the provisions of a licence issued buy the Director
13 and of this agreement Albion Water will provide a continuous supply to the
14 customer."

15 There is reference to essential maintenance works. Then 7.4:

16 "Albion Water should use all reasonable endeavours to provide the customer with the
17 most cost-effective source of water and the most cost-effective treatment of waste
18 water, including the possibilities of effluent water sales. The savings in the cost of
19 supply or services or incremental revenues net of financing operating costs arising
20 from such initiatives as may be agreed between the parties should be shared between
21 the customer and Albion Water in the proportion 70:30 respectively. Albion Water
22 will propose and support measures designed to minimise waste to facilitate the
23 implementation of such initiatives subject to Albion Water's remuneration. Any other
24 related activities shall be carried out at Albion Water's expense."

25 Then there is a list of additional services. So it is certainly true that there is a contractual
26 arrangement whereby Shotton and Albion share in savings in a ratio of 70:30. But in addition
27 to that there is clearly a retail risk for Albion that Shotton will not pay for the water, and there
28 is a retail risk to Shotton that Albion will not supply the water. Dwr Cymru may, in effect,
29 stand behind Albion in terms of the supply of the water, but if Shotton refused to pay the risk
30 would be Albion's and not Dwr Cymru's. So the suggestion this is essentially an entirely
31 bogus set up, which appears throughout the Director's skeleton in my submission is not right.
32 It is real retail contract with real retail risks in it.

33 In addition, as it appears there, but it appears also in the statement of Mr. Jeffrey, this
34 is a real regulated appointment whereby Albion has to comply not only with the regulatory

1 requirements for non-potable water, but also with the stringent regulatory requirements of sales
2 of potable water, and those are real obligations which impose real costs. Just because some of
3 those functions are, in fact, performed by Dwr Cymru at the moment it does not mean that
4 Albion, in order to obtain its licence indeed from OFWAT, does not have to be in principle
5 equipped to perform those functions. It is pointed out to me that under clause 9.4 of the
6 contract there is a liability in damages on Albion if it fails to provide water of suitable quality
7 and that leads to losses as a result.

8 The second element of the business which is evidenced by Mr. Jeffrey is the issue of
9 water consultancy. To some extent that is referred to in the clauses we have looked at. But we
10 might look also at the approach of Dwr Cymru itself in its justification of its large industrial
11 user tariff at tab D of the Reply bundle.

12 THE PRESIDENT: Yes.

13 MR. THOMPSON: Page 26, clause 2.4:

14 “Currently Dwr Cymru do not have a significant resource problem, however the
15 company recognising the importance of water efficiency long term need to protect the
16 environment, and therefore felt that it was important to introduce water efficiency
17 measures. The tariff will include the following. Customers using over 50 megalitres
18 per year will be given the following benefits. Detailed water management data,
19 advice on efficient use of water and benefits of seasonal use, leakage monitoring and
20 additional benefits for users over 250 megalitres per year, water efficiency audits.”

21 As we understand it that is a real service that is provided. Although we cannot look behind the
22 curtain of Dwr Cymru we see no reason to see why such services would not be included for
23 non-potable users just as for potable users, and they appear to be something which is, as it
24 were, bundled into the tariff and therefore we would not accept that the water consultancy
25 services that we provided are not part of the tariff, we have seen no evidence that Dwr Cymru
26 charge separately for it and this at least indicates that in the potable context it is treated as part
27 of the water tariff.

28 The third element, which is evidenced by the contract, is indeed that Albion provides
29 what might be called a brokerage service whereby they seek to scrutinise the prices charged by
30 undertakers such as Dwr Cymru. However, we would submit that this is a perfectly legitimate
31 retail activity which is familiar from other regulated sectors as, for example, the PPRS for
32 pharmaceuticals where the President will recall that there is an issue about the extent to which
33 margins are paid and the prices that retailers can obtain from wholesalers, and, in my
34 submission, that is a perfectly normal retail activity, to try to obtain as low a price as possible

1 which benefit not only yourself but also in the end your customers.

2 THE PRESIDENT: Although here you have only got one customer and one supplier, so it is
3 brokerage on a rather limited scale.

4 MR. THOMPSON: Indeed it is, but if the Tribunal still has the note that I handed up this morning.

5 THE PRESIDENT: Yes.

6 MR. THOMPSON: At the back of it there is a press release from November 1997, where you will
7 see it is headed "Rules to speed up competition in the water industry", and then OFWAT lays
8 out the rules to speed up competition in the water industry, and if you go down about ten lines
9 you will find a sentence starting, "Progress has been slow".

10 THE PRESIDENT: Yes.

11 MR. THOMPSON: And there has been a real lack of transparency.

12 "The parties involved will not share information with each other. The Director
13 intends to stop this and to require more openness. OFWAT is currently handling 25
14 applications for ... appointments. 23 of these involve Enviro-Logic which is seeking
15 the bulk supply of water or sewerage services from an existing water supply company
16 to sell on to one of that company's existing customers, or in one case a green field
17 site. The competitor acts as a middle man driving down the price of supply. This has
18 brought benefits with companies responding by introducing larger tariffs. Ian Bart,
19 the Director-General of water services said, 'These bulk supply agreements must not,
20 however, be seen as the only way or the best way for competition to develop, and that
21 when they do occur the onus is upon the competitor and the existing water company
22 to negotiate together. I only get involved when I am satisfied that agreement cannot
23 be secured.'"

24 So this is part of Albion's business as the heir of Enviro-Logic to seek to promote
25 competition in this way and the legitimacy of this is recognised in the Director's skeleton
26 argument at paras.95 and 96. Although for reasons best known to himself it does not actually
27 mention Albion as carrying on this business but insists on the postman analogy, it is quite clear
28 that Albion does do this.

29 THE PRESIDENT: Yes.

30 MR. THOMPSON: In my submission, Enviro-Logic and Albion are the prime examples in this
31 industry of the businesses involved in this type of brokerage activity. I think we would accept
32 that the primary relevance of that is for the excessive pricing case where it is clear that this is
33 not just a matter for Shotton to receive a reduced price but also it is part of the business
34 rationale of Albion to scrutinise costs because they obtain a share of the benefit. The issues of

1 retailing and water consultancy are of more relevance to the issue of margin squeeze and it is
2 also a matter which is obviously of interest to Aquavita, which I suspect justifies their
3 intervention in this case.

4 As I have said once or twice, the Director draws the analogy with a busybody
5 postman, one might say, who snatches a letter out of the postman's hand, throws it through the
6 door, and insists on a margin for doing it. We say that this is not an apt analogy. First of all,
7 Albion buys the water at source. Albion is responsible – this is under the scheme that we are
8 concerned with here, the first access price – Albion is responsible for the supply to Shotton.
9 Albion is subject to regulatory costs and risks and, in legal terms, Dwr Cymru is a
10 subcontractor from Albion, not a wholesale supplier let alone a retail supplier to Albion.

11 THE PRESIDENT: Can you just remind us at which point the water technically passes into Albion's
12 ownership?

13 MR. THOMPSON: Under the proposal that this case concerns Albion was to purchase the water
14 from United Utilities at Heron Bridge, and, Sir, you may recall there was a metal cover in a
15 field, where we were told, about 100 yards away from Heron Bridge, was where the water
16 passed, so, as it were, title in the water would pass at that point.

17 THE PRESIDENT: As it left Heron Bridge?

18 MR. THOMPSON: As it left Heron Bridge and entered the Dwr Cymru network, at which point
19 Albion would be liable for the cost of the resource from United Utilities.

20 THE PRESIDENT: Yes.

21 MR. THOMPSON: So if one took the postal analogy seriously, this would not be a case of the man
22 standing on the doorstep, or indeed of the man looking at the letter and saying, "Good heavens,
23 this stamp's terribly expensive, that's not good enough, you should reduce your prices", this
24 would be a case of an individual having a relationship with, for example, a bank for delivery of
25 its post to its customers and entering into an arrangement with the Royal Mail to carry those
26 letters from the bank to the customers, and it would bear the risk of getting paid by the
27 customers and it would have to enter into a relationship with the bank to receive the letters in
28 the first place, and we say that legally and commercially that is a quite different situation from
29 the busybody postman.

30 PROFESSOR PICKERING: Could I just ask, that is the intention, it is not the reality at present, is
31 it?

32 MR. THOMPSON: No, because it has not been possible to agree terms indeed either with United or
33 with Dwr Cymru, but that is what this case is about.

34 THE PRESIDENT: Can we just stay with this for a moment, Mr. Thompson. Two questions

1 I suppose, either for now or later: if you were to summarise exactly what the value added is
2 that Albion Water brings to the party, as it were, compared with the situation of Dwr Cymru
3 supplying Shotton direct, what is it exactly? Secondly, if you are right and over time 50 Albion
4 Waters or equivalent brokers emerge and start negotiating with statutory water companies is
5 there any real change in the situation except that a proportion of the revenue currently obtained
6 by the statutory water companies transfers to the brokers without significant general public
7 benefit?

8 MR. THOMPSON: I think I can answer that because it is effectively the outbreak of retail
9 competition, because Albion or Aquavitae ----

10 THE PRESIDENT: Leading to lower prices for the end consumer, you say.

11 MR. THOMPSON: They have an incentive to obtain cheaper water from their suppliers which Dwr
12 Cymru does not have, and they have different motivations to achieve water efficiencies in the
13 retail sector from those of Dwr Cymru. Effectively we are back to the quotation from the
14 Director which comes at the heading of our skeleton argument. It is market competition.

15 THE PRESIDENT: Yes.

16 MR. THOMPSON: One question that I think was in your mind about whether there was any
17 difference in financial terms, there is, in my submission, quite an important and rather
18 extraordinary misunderstanding at para.46 of the Director's skeleton argument which really
19 makes one wonder how far the issue of a margin is really in his mind at all. It is at p.22 of the
20 skeleton argument, and in the second half of that paragraph the Director says:

21 "Malcolm Jeffery asserts that '*a reasonably efficient retailer will require a margin*
22 *between wholesale and retail price of 5p. per metre cubed*', which in this case would
23 amount to a payment of approximately £328,500 per annum to Albion."

24 That, in my submission, is really quite a revealing and extraordinary error because the Director
25 seems to be so far into Dwr Cymru's shoes that he is imagining that if Dwr Cymru is paid less
26 for its water that is to be treated as a payment by Dwr Cymru to Albion, and it seems to assume
27 that the docile end consumer will simply pay exactly the same money whatever the retail price,
28 and it must be either Dwr Cymru having to pay Albion or Shotton meekly paying Albion,
29 whereas a retail margin is no guarantee that the end customer will pay that sum, it is a margin
30 between the end price of the upstream supplier, Shotton, and the whole sale price. There is no
31 guarantee that Albion will be paid that money, it is a retail margin, and, in my submission, it is
32 really quite extraordinary for the Director to equate a retail margin to a payment either by the
33 end customer or by the upstream supplier.

34 THE PRESIDENT: It does say, according to Mr. Jeffery, that a reasonably efficient retailer will

1 require a margin, suggesting that whatever the price between the price at which Albion buys
2 and the price at which it resells to Shotton there will be a 5p. per cubic metre margin, or that is
3 what they are aiming for, which would give them, so the Director argues, £328,500 per year.
4 He says if that is your object that is rather a lot of money for the relatively little that you are
5 doing. That is the argument.

6 MR. THOMPSON: Yes. I think I am now coming on to my, as it were, sixth section, which is the
7 appropriate level of margin, and maybe there is something entirely innocent about that. I must
8 confess I had understood the Director to be treating a margin as effectively equivalent to a
9 payment whereas, in my submission, that is not the position. A retail margin is something
10 which gives someone room to manoeuvre and an ability to compete.

11 If we look at the appropriate level of margin, the reference to Mr. Jeffery's statement
12 is at tab 3 of the reply bundle, and both Dwr Cymru and the Director say this is most
13 extraordinary. Albion is saying that the treatment and distribution costs for this water is of the
14 order of 5p., or less indeed, how can that be so if Albion's retail margin needs to be 5p. There
15 is in fact an answer to that, which is that the regulatory costs of a company such as Albion has
16 to be recovered from its business whereas a company such as Dwr Cymru can spread costs of
17 that kind over its whole business, so it would be quite unreasonable for it to recover that degree
18 of common costs from a relatively small proportion of its business such as this case represents.
19 The question is obviously how far one could allocate costs of that kind, but, in my submission,
20 Mr. Jeffery's evidence is in itself perfectly proper and reasonable evidence, and, apart from that
21 rather rhetorical criticism, in my submission there is no real reason to doubt it.

22 So our essential point, and I think it can be taken perfectly shortly, is that Albion has
23 in effect to recover its costs over much smaller volumes than Dwr Cymru, and that effectively
24 Dwr Cymru enjoys huge economies of scale as against a market entrant, so that nothing is
25 really explained by contrasting the one figure with the other, and, as I understand it,
26 Aquavitae's evidence is consistent with Mr. Jeffery's, that a margin of that sort would
27 effectively be the minimum market opening price, if one uses the jargon.

28 Again we say that the basic error here, as elsewhere, is for the Director to equate
29 Albion and Aquavitae, which are businesses which are entirely legitimately seeking to make
30 money in the water industry with end consumers such as Shotton or Corus, whose money is
31 being made in, for example, the paper or the steel industry, and we say that no retail business
32 could conceivably survive on the Director's approach, that it must be legitimate for a retailer,
33 or indeed a consultancy firm, to make some margin if it is to carry on its business.

34 The final part of these submissions relates to the remedy, and, as I think I said, it falls

1 into four sections. We say that, first of all, the Decision must be set aside. We say in relation
2 to distribution, the reasoning at paras.297 to 302 is plainly inadequate, and we equally say that
3 the reasoning in relation to margin squeeze, which, as we understand it, amounts to no more
4 than saying this is not a legitimate business and therefore good riddance, it is a good thing you
5 have got no margin, and in this respect the Director refers to a policy going back some years at
6 I think para.12 of his skeleton argument, the second half of para.12:

7 “As a result, Albion knew that it would have to add value in some way to justify its
8 Inset Appointment. As Enviro-Logic noted in relation to the Shotton Inset
9 Application ‘[...] *Enviro-Logic proposed adding value by developing an alternative*
10 *source ...*’”

11 Or above that,

12 “*This ensures that there is no margin for the competitor (although the customer will*
13 *benefit*”

14 So it is perfectly true that the Director has taken the consistent policy that companies
15 in the position of Albion are not entitled to a margin, but, apart from that point and the equation
16 of a company like Albion to a retail purchaser, there is no attempt to engage with the fact that
17 in itself a zero margin, which is what is offered here, makes it impossible for an undertaking to
18 carry on its business in the downstream market, and we say that, in substance, the position is no
19 more acceptable here than the Tribunal found it to be in *Genzyme*, and that the reasoning of the
20 Decision in relation to margin squeeze is wholly inadequate and unacceptable.

21 We go further than that and we say that there is here the clear basis for the finding of
22 an abuse on three headings in relation to treatment costs, distribution and margin squeeze. In
23 relation to treatment costs, we say that there was 125 per cent. excessive charge, 7.2p. per
24 metre cubed instead of 3.2p. per metre cubed. That equates, on reasonably conservative
25 assumptions about consumption, to £263,000 per year. That overcharge was identified, as we
26 understand it, in the context of the new tariff towards the end of 2002. The matter was only
27 recognised by the Director in his Decision in the middle of last year, but even then nothing
28 appears to have been done about it so that for a period of about 2½ years Albion has been
29 overcharged by 4p. per metre cubed by Dwr Cymru, which is a sum of somewhere between
30 £700,000 or £800,000, and we say that from the time when this matter was identified by the
31 Director. At the very least it has been an abuse for Dwr Cymru to continue to charge that sum
32 from a company in the difficult financial position of a company such as Albion. This was
33 raised in our skeleton argument and it has not been answered either by the Director or by Dwr
34 Cymru.

1 The second point in relation to distribution: we say that when one looks at the figures
2 and looks at the facts the distribution charge is blatantly excessive when one looks at
3 comparators and the underlying cost drivers and, in particular, the comparative valuation of the
4 600 mm potable pipeline as against the pipeline with which we are concerned in this case. We
5 say that that is sufficiently clear, that it is plain that there is an abuse in relation to the
6 distribution price.

7 Thirdly in relation to margin squeeze, we say that a 0 per cent. margin is equally
8 plainly not acceptable and that it represents an exclusionary and an exploitative abuse parallel
9 to those found by the Tribunal in *Napp* and *Genzyme*. In the *Napp* case there was a
10 combination of predatory pricing on the hospital market for a drug which was used to protect
11 excessive monopoly prices on the consumer market. In the *Genzyme* case a margin squeeze
12 was used to prevent competitive market entry on a downstream market for ancillary services
13 for the supply of a drug. Here we say that the anticompetitive strategy is a clear combination of
14 the two. A margin squeeze on a potentially competitive downstream market is being used to
15 protect monopoly profits, excessive prices, on the minimal upstream transport services market
16 in particular, and so we say that there is the classic combination of an exclusionary and
17 exploitative abuse. Albion and Aquavitae are unable to find any toehold in this market, and the
18 monopoly pricing continues as a result.

19 The third question is what should be done about this. In my submission, that would
20 require a detailed analysis either by this Tribunal or by the Director applying the correct
21 principles in relation to margin squeeze and excessive pricing, and showing somewhat more
22 rigour in getting to the underlying cost position and in seeking to open the market to legitimate
23 downstream competition. However, I do not think it is necessary or appropriate to attempt to
24 work out what the correct mechanism should be and how the correct figures for the distribution
25 price in particular or the margin should be calculated. I go no further today than to say that a
26 margin is required and that the price is clearly excessive.

27 Finally in relation to interim measures, I would simply refer to the submissions that
28 we have made at the end of our skeleton argument, but, in addition, I would say that the 4p.
29 discount or overcharge identified at para.294 of the Decision should be built into any price that
30 is charged in the interim, and that that at least should be recognised as a legally impossible
31 position for the Director or Dwr Cymru to maintain into the future given the terms of the
32 Decision itself and the adverse effects on Albion's commercial position, which has existed for
33 some two years and should be brought to an end without any further delay.

34 Sir, those are my submissions on interim relief. Can I just see if anyone wants me to

1 say anything else? (After a pause): Sir, those are our submissions.

2 THE PRESIDENT: Thank you, Mr. Thompson. Mr. O'Reilly, I do not know if you have got a
3 particular time estimate. We were going to rise for a couple of minutes anyway now before
4 you start. I do not know whether you envisage finishing today or how you see it.

5 MR. O'REILLY: If it is just going to be a couple of minutes then I should certainly be finished
6 today.

7 THE PRESIDENT: Yes. I do not particularly want to sit much beyond half past four today.

8 MR. O'REILLY: I did think 30 minutes. We did promise to be a low maintenance Intervener and
9 we hope to stick to that.

10 THE PRESIDENT: Very well. We will rise for a minute or two.

11 (Short break)

12 MR. O'REILLY: Sir, our intervention is broadly in support of Albion's position insofar as our
13 intervention is permitted, which is of course of fairly limited scope, and if I could just refer
14 you, without taking you to them, to the Statement of Intervention and to the skeleton. Sir, this
15 is in some ways an appeal about Shotton Mill, but, more specifically, Sir, it is an appeal about
16 the Decision made by the Director, and, in my submission, it is an appeal which goes not just to
17 the final number that he comes up with but to the reasoning process by which he gets there, and
18 in para.324 of his Decision he refers to and sets out the costs principle and uses that as – and
19 the terminology we are using here is as a cross-check, but, in my submission, he is using that as
20 one of the planks for his Decision, and so it is not a cross-check necessarily after the event, it is
21 part of his decision-making process, and, in my submission, it is an issue in this appeal.

22 Mr. Thompson has broken down the approach into whether an error of law was made
23 and whether an error of fact was made. In our submission, that must be right; the question is
24 was s.66E correctly interpreted; and, secondly, in relation to errors of fact, did the Director
25 make the correct deductions and did he start at the right place when coming to his calculation.
26 His calculation is set out most explicitly in para.330 of his Decision. He says that under a retail
27 minus approach the access price would be 25.8 minus the avoidable cost of resources.

28 "These avoidable costs would be the specific costs attributable to the assets used to
29 supply the customer, in this case the water supplied by United Utilities Water from
30 the Heron Bridge extraction point to Dwr Cymru under the first bulk supply
31 agreement."

32 Effectively, what he says is the correct deduction from the retail price, which he takes
33 as the starting point, is the cost of the United Utilities water, and that is how he arrives at the
34 final figure. In doing that calculation, which he purports to carry out in accordance with cost

1 principle, he fails to take into account a number of things. It has already been mentioned that
2 the reduction in para.294 has not been taken into account, gives a reduction of 4p., and, in our
3 submission, he fails to take into account the various costs associated with retail which would no
4 longer be required.

5 In the appellant's reply at tab D, p.27, there is a Dwr Cymru document, and at the top
6 of p.27 it says that the tariff will include the following, customers over 50 megalitre, and of
7 course that is the threshold figure, under the new regime will be given the following benefits,
8 detailed water management, advice on efficient water, leakage monitoring and for the very
9 large users water efficiency audits. So there is no doubt that the appellant in this case falls into
10 one of those categories.

11 Moreover, he fails to take into account the normal retail costs, and of course this is
12 where Aquavitae's primary interest in the first instance arises. A number of examples are set
13 out in our skeleton. If I could put the downside of our case first, at para.35 we refer to a
14 number of activities that the new entrant might be required to undertake but conceivably also
15 the existing undertaker would continue to undertake. That might include metering, invoicing,
16 debt management, corporate overheads and so on. So we accept that there may well be an
17 element of duplication. Some things we have referred to later in para.35, such as market
18 intelligence, where the operator on the market keeps a weather eye out for what is happening.
19 We are saying that that would be an activity that the previous supplier might continue to
20 undertake but could not be said to be something that was chargeable against the new entrant.
21 But there is an enormous range of activities which the new entrant would carry out and the
22 existing undertaker would no longer carry out and we could go into billing, calculation,
23 processing, printing, dispatch ----

24 THE PRESIDENT: Sorry, billing...?

25 MR. O'REILLY: I have a very long list, Sir, and if I could just give you a flavour and then perhaps
26 hand in a schedule overnight?

27 THE PRESIDENT: Yes. The items I have here are billing, calculation, processing, printing, and
28 dispatch of bills, overdue debt, follow up, including reminder notices, letters outbound calling,
29 visits, use of debt collection agencies, field collectors, disconnection, court fees and so on. So
30 t here is a considerable array of activities that a retailer undertakes, in this case the new entrant
31 would undertake, and the previous supplier would not. In the case of Shotton we have a very
32 singular situation, of course, because there is only one customer, and we recognize that.
33 Nonetheless, we say the failure of the Director in this case to look in principle at these matters
34 amounted to an error of fact, because on the correct interpretation of s.66E he should have

1 done so. Our complaint is that he failed to do that at all, and accordingly attacks the problem
2 in the wrong way. We take issue also with what must have been his interpretation of s.66E as
3 derived from the Decision. I do not know whether I am able to assist you any further in the
4 interpretation of that. In my submission it is a very oddly drawn section and is going to give
5 anyone who interprets it some difficulty. In my submission, all I can say really is that there is
6 a top tier principle which is that the figures in s.66(1) whether A and B, will be recoverable
7 first and then there will be deductions as set out in the remainder of that section. Those will
8 include giving credit for financial benefits it receives (if any), and as you have identified, Sir, it
9 is quite difficult to identify exactly what those benefits might be. Some account of the sums
10 the undertaker reasonably expects to recover from the relevant customer, but is unable to
11 recover as a result of the new licence making the supply; and thirdly, a prohibition in respect of
12 arrow cost, which are costs avoided, reduced, or recovered in some other way.

13 In my submission, the Director first of all makes an error of law; and secondly, has
14 not approached the question of fact correctly either. We do not make detailed submissions
15 about what the right figures would have been, because we believe that that is outside the ambit
16 of our intervention, and what we are looking for is an indication that the submissions in
17 principle are correct. Our submission is that the Director's entire philosophy and approach to
18 competition is exemplified by his decision Shotton, both historically and in relation to the
19 future. Frankly, he cannot help himself but to take a position as to the future. Cost principle
20 was not in effect when he gave this Decision but he nevertheless went into that arena.

21 His postman analogy is contemptuous of the whole arrangement, in my submission,
22 set up by Parliament. Again, it is telling that, even on this analogy, he fails to do the analysis
23 correctly. Of course, if one has a long terrace of houses that front straight out into the street,
24 then of course walking down to the garden gate involves zero distance, and zero energy. But
25 out in the countryside, which might be the right analogy for large users one has to go from the
26 farm gate, as it were, up to the farmhouse and back down again. So that journey might be a
27 much more significant proportion of the total. Of course, what new retail entrants want is a
28 margin and it will be a fairly small margin compared to the total cost, and what the Director
29 has done is to dismiss that margin as being perhaps one or two, maybe four or five per cent.
30 and of little worth. But in terms of magnitude of this industry those sorts of margins can be
31 significant. That is the sort of margin that a new entrant might start off with and once the
32 market matures the margins will improve and competition, and the benefit to the consumer,
33 will improve. This is certainly the position in the gas and electricity industries, which has not
34 been raised this morning. The same sort of arguments that the Director puts in relation to the

1 water industry could also have been taken by the Regulator in those industries at that
2 appropriate time, and yet in my submission the Tribunal might take judicial notice of the fact
3 that there have been significant savings in those industries.

4 Finally, I just want to say something about the Competition Act 1998.

5 THE PRESIDENT: There are similar brokerage type operations in Telecoms as well.

6 MR. O'REILLY: Yes. Indeed, in every utility sector that you might care to think of exactly the same
7 sort of arrangements might obtain.

8 In relation to the Competition Act 1998 the Director does not say so explicitly, but in
9 my submission it is implicit from his Decision that he believes that the Competition Act will
10 not apply to the new regime. In my submission he is wrong. He is wrong as a matter of
11 principle and construction because if such drastic change in competition law in this sector were
12 to have been in the contemplation of Parliament and the intention of Parliament they would
13 have said so.

14 If the correct interpretation of s.66E necessarily requires that there be no margin then,
15 of course, the undertaker is covered. If we simply have legitimate operators on a legitimate
16 market in the ordinary way then all principles of margin squeeze in my submission will exist
17 and certainly no one can read without concern s.66E as giving a licence to undertakers to
18 commit a margin squeeze or to levy an excessive price.

19 Clearly modesty forbids me saying, even on behalf of Aquavitae, that a much better
20 place the market would be with us in it, and I shall sit down at that point unless there are any
21 further questions.

22 THE PRESIDENT: Thank you, Mr. O'Reilly. Very well, I think that probably, Mr. Anderson,
23 brings the proceedings for today to an end, unless there is any point you need to raise tonight, it
24 is probably a bit late.

25 MR. ANDERSON: There is no point I wish to raise. I will start fresh tomorrow.

26 THE PRESIDENT: We will start fresh tomorrow when we have had a chance to absorb some of the
27 things that have been said. So we look forward to hearing you tomorrow. Thank you very
28 much. 10.30 tomorrow.

29 (Adjourned until 10.30 a.m. on Tuesday, 10th May, 2005)