

This Transcript has not been proof read or corrected. It is a working tool for the Tribunal for use in preparing its judgment. It will be placed on the Tribunal Website for readers to see how matters were conducted at the public hearing of these proceedings and is not to be relied on or cited in the context of any other proceedings. The Tribunal's judgment in this matter will be the final and definitive record.

**IN THE COMPETITION**  
**APPEAL TRIBUNAL**

Case No. 1046/2/4/04

Victoria House,  
Bloomsbury Place,  
London WC1A 2EB

15 February 2008

Before:  
MARION SIMMONS QC  
(Chairman)

THE HONOURABLE ANTONY LEWIS  
PROFESSOR JOHN PICKERING

Sitting as a Tribunal in England and Wales

BETWEEN:

**(1) ALBION WATER LIMITED**

-and-

**(2) ALBION WATER GROUP LIMITED**

Appellants

-v-

**WATER SERVICES REGULATION AUTHORITY**

Respondent

-supported by-

**DŴR CYMRU CYFYNGEDIG**

-and-

**UNITED UTILITIES WATER PLC**

Interveners

---

Transcribed from tape by  
Beverley F. Nunnery & Co.  
Official Shorthand Writers and Tape Transcribers  
Quality House, Quality Court, Chancery Lane, London WC2A 1HP  
Tel: 020 7831 5627 Fax: 020 7831 7737

---

**HEARING DAY TWO**

## APPEARANCES

Mr. Rhodri Thompson QC and Mr. John O’Flaherty (instructed by Palmers Solicitors) appeared on behalf of the Appellants.

Mr. Rupert Anderson QC and Miss Valentina Sloane (instructed by the Head of Legal Services, Water Services Regulation Authority) appeared on behalf of the Respondent.

Mr. Christopher Vajda QC and Mr. Meredith Pickford (instructed by Wilmer Cutler Pickering Hale and Dorr LLP) appeared on behalf of Dŵr Cymru Cyfyngedig.

Mr. Fergus Randolph (instructed by United Utilities plc) appeared on behalf of United Utilities Water plc.

---

1 THE VAJDA: Good morning. I am happy to say that in the spirit of compromise we have  
2 decided, having taken instructions, to waive confidentiality in Mr. Thompson's note, the  
3 confidential note, that is why Mr. Randolph is in court. We waive confidentiality in the whole of  
4 the note which includes those bits of the note that refer to some of the confidential documents.  
5 We still maintain confidentiality in relation to those documents, but it does not really matter  
6 because the only issue is really how Mr. Thompson deals with it in his notes. On that basis we can  
7 proceed in open court.

8 What I would like to do now is very briefly deal with that note, if the Tribunal has it to  
9 hand. I want to go to para.8, which is the paragraph Mr. Thompson took us to yesterday. A  
10 point of interest is Mr. Holton's comment in respect of para.6 of Albion's letter. As I  
11 understand it the Albion letter is annexed to Mr. Thompson's note. If we go to that, para.6,  
12 which I think is the one over the page – it begins: "The Bulk Supply Agreement".

13 THE CHAIRMAN: Yes.

14 MR. VAJDA: So Mr. Holton's comment in respect of para.6 is in relation to the Bulk Supply  
15 Agreement, it is not in relation to common carriage or anything, it is in relation to the Bulk  
16 Supply Agreement. What he was referring to there was the scope of obligation in the Bulk  
17 Supply Agreement, not whether there was an obligation at all but it is common ground that  
18 you got the back-up with the bulk supply, so that is the comment I want to make on para.8  
19 of the note.

20 The other point I can deal with much more shortly, and Mr. Randolph may wish to come  
21 back on this, but there is a point at para.4 of the note, this is the belief that the agreement  
22 between what is now United Utilities (formerly NWW) and Dŵr Cymru was anti-  
23 competitive. It is impossible, in our respectful submission to see how a belief by a third  
24 party that an agreement is anti-competitive could in any way be relevant to the question of  
25 whether the first access price, which does not involve the supply of water, is abusive, and in  
26 any event courts do not proceed on the basis of beliefs, they proceed on the basis of findings  
27 in relation to facts. That is all I need to say on that, and we can put away the confidential  
28 note.

29 Can I then come back to where I was yesterday, and really pick up the point that Professor  
30 Pickering asked me in relation to the back-up supply for Albion. We say that when the  
31 Tribunal asked the Authority the cost of transportation and treatment of water by Dŵr  
32 Cymru generally, and through the Ashgrove system in particular, it must have been taken to  
33 ask that question by reference to how those terms were used to calculate the first access  
34 price. We say that that follows from question two that the Tribunal asked which was

1 whether, in the light of those costs, the first access price was an unfair price. What I am  
2 saying is that one reads the Tribunal's questions 1 and 2 together. The critical issue, as we  
3 see it was whether the first access price was excessive if it had been applied to and paid by  
4 Albion, and that is why the Tribunal asked for more granularity than provided by the AAC  
5 methodology. There is no question that Albion needed the back-up supply and I gave the  
6 Tribunal yesterday the evidence relied on by the Authority at 540 to 548 of the Final  
7 Report. Perhaps I could flag up that within that is the evidence of Mr. Jeffrey which is  
8 quoted at 543.

9 PROFESSOR PICKERING: Mr. Vajda, you used the definite article "the" back-up supply. Was  
10 it the specified back-up supply or a back-up supply that was being required?

11 MR. VAJDA: In relation to the common carriage the position of the Authority is that Albion  
12 required what they were getting under the Bulk Supply Agreement; it was effectively the  
13 same back-up supply that they were getting under the Bulk Supply Agreement that they  
14 would require under the Common Carriage Agreement. I think the wording in the final  
15 report is "the Back-up" at 5.47. There is no dispute that the back-up supply is, if I can put it  
16 like this, Albion specific cost. If I could just give the two references to the Tribunal – the  
17 Authority's response at 21-22, and also their comments at the schedule at pp.1-4.  
18 I made the point yesterday, just to remind the Tribunal, that at 5.62, the third bullet of the  
19 final report the Authority pointed out that the FAP was based on the AAC approach which  
20 included all costs, including back-up supply. If one adopts a more granular form of AAC  
21 the view of the Authority was that they should include it as an Albion specific cost.  
22 That brings one on to the point that Professor Pickering asked yesterday, "Why is back-up  
23 supply treated differentially, for example, than distribution pumping which is not an Albion  
24 specific cost that Albion pays for?" That, we say, is dealt with by the Authority at paras.21  
25 and 29 of the response, which is that the back-up supply is a distinct and necessary part of  
26 the service provided by Dŵr Cymru to Albion, which is not the case for distribution  
27 pumping.  
28 Professor Pickering put to me the point, is there not a bit of unfairness here, and I said that  
29 you look at the swings and roundabouts. One of the important points in relation to swings  
30 and roundabouts is to look at the two other methodologies. The LAC methodology, which  
31 is, if you like, the real disaggregated methodology, the one that effectively Albion was  
32 pushing for from the beginning, excludes distribution pumping. So the LAC bulk  
33 distribution costs are lower than the AAC plus average. This is at paras.27-29 of the  
34 response.

1 PROFESSOR PICKERING: I am just looking at the summary total at 1.14.

2 MR. VAJDA: Yes. I think I am not really saying anything new. I am only repeating what the  
3 Authority says in its response. In relation to LAC Albion does better in the sense that  
4 distribution pumping is out because it is not an Albion specific cost, but it does worse in  
5 relation to water and sludge treatment and operational control costs because those costs are  
6 higher on an Albion specific basis than the regional average. That is paras.27-29 of the  
7 response.

8 Then also we have the third methodology, and obviously one has to look at this in the  
9 round, which is the LRIC methodology which, as we know, is Ashgrove specific. It  
10 excludes the back-up supply altogether. It is important to note, and this will be relevant  
11 when we look at economic value, that the Authority acknowledged, and if one looks at 5.66  
12 of the final report one sees this, that it has not included the cost of back-up supply in its  
13 LRIC methodology. However when setting an access price on LRIC, it might be sensible to  
14 add on the cost of the back-up supply to ensure full cost recovery. Dr. Marshall recognised  
15 the need for mark-up on LRMC based prices to ensure full cost recovery in her report.  
16 So the approach of the Authority is – and this is perhaps part of the question that Madam  
17 Chairman asked me yesterday, a perfectly sensible and searching question, which is why on  
18 earth did the Authority not include back-up supply in the LRIC calculation, - they did not  
19 include it but they effectively said, “Well, you should still make an allowance for it”. The  
20 particular reason why they did not include it, Madam Chairman, is to be found at 6.24 of the  
21 final report, p.64:

22 “The Authority’s LRIC model is ‘pure’ in the sense that it is close to the textbook  
23 model of LRIC by estimating the cost of supplying an increment in demand. As a  
24 result, it excludes costs such as the back-up supply and common costs which do  
25 not vary with the increment in demand.”

26 So that is the reason they give.

27 If we then look at 6.28 we see that at the tri-partite meeting held on 18<sup>th</sup> May, and this is  
28 where there was a shift. There was a shift because the Authority acknowledged Albion’s  
29 point that a pure LRIC model would not include the cost of the back-up supply. That was  
30 an adjustment made in Albion’s favour, but the Authority qualified that by saying:

31 “The Authority did however state that when setting an access price based on the  
32 LRIC methodology it would seem sensible to add on the cost of the back-up supply  
33 to ensure fully cost recovery.”

1 While we have got the final report open could I just ask the Tribunal to go to p.31, para.5.6.  
2 You will recall yesterday that I said that there was an element of hypothesis in the present  
3 case, because there never was a Common Carriage Agreement. I said that, in fact, when  
4 Albion produced the figure of 23.2 per cent, it then asks Ofwat to approve it. The  
5 chronology in relation to all that is set out at 5.6 to 5.12. You will see at 5.6 that Dŵr  
6 Cymru wrote to the Authority on 20 February. Then the Authority replied criticising Dŵr  
7 Cymru for the delay in giving an indicative access price. What the Authority asked for,  
8 rather than effectively going into approval, it says at 5.7 that it:

9 “... expects both parties to discuss the indicative price in a proper and professional  
10 manner. I would also expect Dŵr Cymru to comment on Albion’s proposed access  
11 price as part of this negotiation progress.”

12 So what the Authority was envisaging was a process of negotiation. It was that process of  
13 negotiation that then really comes to a premature halt because Dŵr Cymru then wrote to  
14 Enviro-Logic on 2<sup>nd</sup> March, 2001, setting out the access price. Then we see at 510 Enviro-  
15 Logic reply to the Authority on 7<sup>th</sup> March,

16 “You have asked that [Albion] should negotiate constructively with Dŵr Cymru.  
17 Dŵr Cymru’s continuing refusal to do so was part of our original complaint on  
18 which we are seeking a resolution from [the Authority] as a concurrent competition  
19 regulator”.

20 Then at p.511,

21 “Further to my letter of 7<sup>th</sup> March, 2001 I now write to inform you that having  
22 reviewed Dŵr Cymru’s methodology and indicative access price, [Albion] is now of  
23 the view that this constitutes and maintains an abuse ----”

24 So, that is what actually happened. That is why things never proceeded any further.

25 THE CHAIRMAN: Did you find out the answer to my other question, which was whether they  
26 did have to approve it?

27 MR. VAJDA: The Tribunal should have - and this is because I am very conscious of the time  
28 pressure - two documents which have been handed up to the Tribunal - or are going to be  
29 handed up to the Tribunal. In relation to the notes there is s.2 of the note which deals  
30 precisely with the point which you, Madam Chairman, have raised. That is dealt with at p.4.  
31 I am not proposing in view of the time to go into that. However, that is what we say on that.

32 THE CHAIRMAN: Thank you very much.

33 MR. VAJDA: The last thing I want to say before coming to this note - and in a sense this is a bit  
34 of law - is that yesterday I mentioned the burden of proof. Perhaps I can just give the court

1 the references to the two cases that I was referring to. First of all, the *Napp* case. I am not  
2 going to go to it because I think it is pretty clear. If I can just give the Tribunal the  
3 references -- the *Napp* case is at Tab 12 of the bundle of authorities. The passage that I refer  
4 to - which is now a sort of classic passage - are paras. 107 and 108, which is that strong and  
5 convincing evidence will be required before infringements can be proved even to the civil  
6 standard. In practice, this is the same as beyond reasonable doubt”.

7 THE CHAIRMAN: That has been qualified slightly by the JJB.

8 MR. VAJDA: Yes. The other case, which is particularly important in relation to excess pricing,  
9 is *Scandlines*, at Tab 8, para. 244.

10 THE CHAIRMAN: If we are looking at *Napp* and the burden and standard, we do need to look at  
11 *JJB* as well.

12 MR. VAJDA: Yes. What I would like to do is to come to this note. I can just deal with this  
13 piece of paper very shortly. You will see from our reply skeleton - and, indeed, from the  
14 observations we made to the Authority - that there are a number of matters which Dŵr  
15 Cymru had criticisms of the report. Some of those matters were taken up by the Authority  
16 in their response document, but there are still some matters (if I could put it this way) which  
17 are outstanding. If you like, these are the sort of equivalent of a little table that Mr.  
18 Thompson put in yesterday. I am not going to go through them, but we have just sought to  
19 identify them for the Tribunal in this form. This is all, of course, subject to my over-arching  
20 submissions yesterday as to what the role of the Tribunal is. We have prepared this in terms  
21 of trying to ease the Tribunal’s task. I hope that is of assistance.

22 Can I come then to what I call ‘the note’? This is intended, I hope, to speed things up. The  
23 Authority, as we know, looked at three methodologies. Quite a lot of the focus yesterday  
24 was on the AAC-plus methodology. I think time will not permit me orally to deal with all  
25 the points of detail in relation to AAC-plus. It may be that Mr. Anderson will deal with  
26 them. What I what just to do for a moment is to stand back to look where one is altogether,  
27 because one must not forget the LAC and the LRIC methodologies. What one is seeking to  
28 do - as happens in these cases - is to try and assess, and come to an answer on what is a very  
29 difficult question. What we say is that Albion has failed to mount any effective challenge,  
30 either to the LAC or the LRIC methodology, whether on a JR approach or any other.

31 In relation to LRIC the only real attack on LRIC is the point about 10 percent or 20 percent.  
32 We say that that entirely misunderstands the economic underpinning of a long-run  
33 incremental cost. I do not think I need to expand on para. 3 which really reinforces the

1 points we have made in writing, and the Ofcom document which we have referred to in our  
2 reply skeleton.

3 If we come to LAC, you will recall that LAC is a bottom-up methodology. It is the nearest  
4 there is to, if you like, an Albion-specific price. What the Authority say is that although it is  
5 called a local accounting -- They say it is not really so much accounting as hybrid, but it is  
6 the most local and it is bottom-up. Effectively, this is a cross-check to other methodologies  
7 to the AAC-plus, which is top-down. This, as I have already indicated, includes services  
8 that Albion clearly requires from Dŵr Cymru and uses, such as back-up, but excludes cost  
9 categories such as distribution pumping where there is no such function provided at the  
10 Ashgrove system. So, it does not suffer, in a sense, from the swings and roundabouts in  
11 relation to the methodology that rely on some degree of averaging.

12 There were a number of points made in relation to LAC yesterday. So far as the challenge  
13 to the methodology was concerned, which I think was (g)(d) of Mr. Thompson's of points,  
14 the basis of that was really the twenty-four page note which was put in on Monday of this  
15 week -- Monday of this week seems like three years ago in this case; a lot has happened  
16 since then. But, it was only on Monday. It was purportedly provided to answer to a point of  
17 clarification for the Tribunal on Friday. I am not going to read out what is said at (a) - the  
18 Tribunal can read that for itself. At (b) it raises a number of challenges to the allocation of  
19 regulation costs, challenges to capital cost figures, and challenge to general support costs.  
20 These are all new points. The Tribunal may have observed - and if it has not observed, may  
21 I draw it to the Tribunal's attention - that these are all comments on the final report. Indeed,  
22 it may be - although this document does not in fact run to twenty-nine pages - that the  
23 Tribunal may recall that Mr. Thompson indicated at some point that Albion had quite a long  
24 commentary on the final report at the last CMC.

25 Now, the appropriate moment, in my respectful submission, to make comments on the final  
26 report was within the timetable laid down by the Tribunal. So, we say that simply from a  
27 procedural fairness point of view the Tribunal should not entertain the note. We, in the short  
28 time available - and we have been working on a number of other matters - think that there  
29 are a number of major errors in the note. We say that it would plainly be wrong for the  
30 Tribunal to have any regard to the note without giving the other parties an opportunity of  
31 dealing with it. The question is: Does the Tribunal want to do that, given the clear timetable  
32 that the Tribunal laid down at the CMC in October?

33 THE CHAIRMAN: Is that something we need to consider now?

1 MR. VAJDA: Not really. This is by way of background. The main point is really that there is  
2 nothing -- if we go to 5.2 -- This is the attack on the LAC methodology under DD. If one  
3 turns up the Scott schedule we see what Albion says at the time. This is in response.  
4 “Albion does not object to the LAC methodology itself. However, its results are  
5 systematically flawed”.

6 We say that DD is not adding anything new and that even on a more than JR basis no  
7 credible attack on the approach that the Authority took on LAC.

8 THE CHAIRMAN: If what you are saying is that we should ignore what is in Mr. Thompson’s  
9 note because it was not contained in the Scott Schedule, first of all, is it accepted that it was  
10 not contained in the Scott Schedule?

11 MR. THOMPSON: No, the basic assumption is false. We received a faxed letter late on Friday  
12 and it took a great deal of work both by me and Dr. Bryan to answer that which no doubt  
13 the fact that we have been in this case, in my case for nearly four years, and Dr. Bryan for  
14 nearly seven – probably 10 – means that some of the material is not new given it is  
15 essentially the same issue that we have been debating over this period.

16 THE CHAIRMAN: It may just be language – just the way it has been put.

17 MR. THOMPSON: I think the major figure is the cost of capital issue, and the other one is the  
18 MEAV issue which I dealt with yesterday and which features prominently in the schedule.  
19 The working out of the precise numbers in a convenient form was because I thought the  
20 Tribunal was asking for it and that is what we have done. If the calculations are wrong  
21 obviously Mr. Vajda can point it out.

22 THE CHAIRMAN: What I think Mr. Vajda is submitting is that the way you justified the figures  
23 in the note on Monday – the very useful note on Monday – raised matters which were not  
24 raised in the Scott Schedule, so what I was asking is whether that is accepted?

25 MR. THOMPSON: Not in a bold sense like that. If there are particular points which people want  
26 to raise, then ----

27 THE CHAIRMAN: Well he has said it here in 5.1(b).

28 MR. THOMPSON: Without going through it, my recollection is that we do challenge regulatory  
29 costs, capital costs and general and support costs. Whether there is a more specific issue, I  
30 do not think I am in a position to make this – I am not sure it is the right moment for me to  
31 do it anyway. I think it is a rather vague challenge at the moment.

32 MR. VAJDA: I agree with Mr. Thompson; it is probably not the right moment. I am conscious  
33 of the time. The big point here is the point that there has been no sustained challenge to  
34 LAC methodology, but there is – if I can put it this way – the procedural point – and maybe

1 the sensible thing in view of the time is to park the procedural point; we have made our  
2 point and if the Tribunal want to get into that, Mr. Thompson may wish to reply at some  
3 point and the Tribunal may wish to hear from me, but I am anxious to get on with ----

4 THE CHAIRMAN: I am just concerned, if you are saying that you have not had an opportunity  
5 to respond that if you want an opportunity you ought to be given an opportunity ----

6 MR. VAJDA: Yes.

7 THE CHAIRMAN: -- if it was necessary, but if it was all raised anyway then your point is not a  
8 good point and therefore you do not need the opportunity.

9 MR. VAJDA: Again, we are short of time and really we do not want to go down the byways, but  
10 if one looks at flag 11 in the appendix, you will see it is headed "The Authority's Final  
11 Report", does the Tribunal see that.

12 THE CHAIRMAN: What are you actually looking at – what volume are you looking at?

13 MR. VAJDA: Volume 41, flag 11, it is the appendix. You see it says: "The Authority's Final  
14 Report. A summary of Albion's Analysis to the Authority's Final Report" is all dealing  
15 with the final report and things have moved on since the final report.

16 THE CHAIRMAN: So which appendix are you looking at?

17 MR. VAJDA: The Tribunal has the "Note in response to the letter from the Tribunal of 8  
18 February 2008" and behind that is an appendix.

19 THE CHAIRMAN: I have the appendix.

20 MR. VAJDA: Which is headed: "Albion Water bet estimates of the effects of necessary  
21 corrections on the conclusions of the Authority". Then you see it says: "The Authority's  
22 Final Report", it is all dealing with the final report.

23 THE CHAIRMAN: Yes.

24 MR. VAJDA: Which, of course, that is what one was required to comment on by whatever date it  
25 was last year, to go into the Scott Schedule. It does not deal in any way with the response,  
26 which is where we now are and it has "Summary of Albion's Analysis of the Authority's  
27 Final Report", and has the figures here, which are figures in the final report. They make no  
28 effort to look at what is in the response because there have been adjustments made to the  
29 figures, and my short point is this ----

30 MR. THOMPSON: Sorry, just before Mr. Vajda takes a bad point he might want to look at paras.  
31 6 and 44.

32 THE CHAIRMAN: Of the appendix?

33 MR. THOMPSON: Yes.

1 MR. VAJDA: Yes, it is true that there is an asterisk which says there are adjustments made in  
2 relation to that, but most of this is directed to the final report. My simple point is that if,  
3 effectively, as Mr. Thompson says it is all in the Scott Schedule we do not need it in any  
4 case, because that is what the parties have and so we can disregard it, but I do not want to  
5 take time now because there are much more important things to deal with in this case.  
6 The main point is that we say there has been no effective attack, whatever test – whether  
7 you use JR merits – on the LAC methodology.

8 MR. ANDERSON: I hesitate to interrupt my learned friend, but on this particular point, if I could  
9 just make clear what the Authority’s position is, we are quite satisfied that this appendix  
10 contains facts, assertions, assumptions and figure that have never appeared before, and we  
11 have not had an opportunity to consider it and my submission would have been that the  
12 Tribunal should disregard it or if it is minded to take account of it it should bear in mind  
13 that they are figures that are not accepted and that have not been subjected to any critique  
14 by either the Authority or Welsh.

15 MR. VAJDA: Good, well with Mr. Anderson’s words ringing in my ears can I move on? The  
16 next topic, which I am not going to deal with orally, is the point that madam Chairman  
17 asked yesterday, and that then takes me to issue 2, which is at p.5, which is obviously of  
18 critical importance in this case, namely, the unfairness issue. I would ask the Tribunal to  
19 take up vol.42, and look at the *Scandlines* case, which is at flag 8. This is the most recent  
20 and full and authoritative approach of the European Commission on excessive pricing; it is  
21 2004 – that is important to note, because I will have to make submissions in relation to  
22 *Deutsche Post* but this supersedes *Deutsche Post* which was 2001.  
23 This is, if you like, an old economy style case. The Port had a wonderful position due to its  
24 location, that is the port of Helsinborg, and if we could just go to p.18 of the Commission’s  
25 decision. You will see that on the “relevant market” that the Commission found that the  
26 Port had a 100 per cent market share – a natural monopoly. I should say this decision is the  
27 rejection of a complaint, there was the complaint of excessive pricing which the  
28 Commission rejected. Paragraph p.72:

29 “... the relevant market in this case is the market for the provision of port services  
30 and facilities in HHAB of Helsinborg to ferry-operators transporting passengers  
31 and/or vehicles on the Helsinborg-Elsinore route.”

32 If we then go to para.79:

33 “For the purposes of the present decision ... it is therefore assumed that HHAB  
34 holds a dominant position on the relevant market. It is the sole provider of port

1 facilities and services for ferry services transporting passengers and vehicles on  
2 the Healthcare at Home-route. There is no possibility for any other undertaking to  
3 enter the upstream market as regards the provision of port facilities and services at  
4 Helsinborg.”

5 So one could not have a more dominant undertaking than the port. We then come to the  
6 analysis of the Commission on excessive pricing, and if we can go to p.33 – I am not going  
7 to read what is on p.33 but if I could just draw the Tribunal’s attention to paras. 145 – 150,  
8 and effectively what they are doing – and I think that this is now common ground between  
9 the parties – is that it is a two-step process, and they base themselves on *United Brands* and  
10 we see at para.147:

11 “The questions to be determined are ...

12 (i) ‘whether the difference between the costs actually incurred and the price  
13 actually charged is excessive and, if the answer to this question is in the  
14 affirmative,’

15 (ii) ‘whether a price has been imposed which is either unfair in itself or  
16 when compared to the price of competing products’.”

17 At para.150:

18 “A comparison between the price charged and the costs incurred (in the present  
19 case, the *approximate* incurred costs) ...”

20 That again is important because one of the points the Commission makes is how difficult it  
21 is to do a cost analysis –

22 “... can only serve as a first step in an analysis of excessive or unfair pricing. The  
23 *United Brands*’ judgment made clear that such an abuse can only be established  
24 where the price bears no reasonable relation to the economic value of the product  
25 concerned.”

26 One of the issues in that case was whether or not one could find that the price was unfair  
27 when compared to the price of competing products, whether you could do a comparison.

28 What the Commission said at p.34 at para.155 – 157 is that it is very difficult to do a  
29 comparison. This was the starting point of the analysis.

30 Having said that, and you see the difficulties, then at para.162 the starting point of the  
31 Commission’s analysis was to see whether you could do a comparison, and what you see –  
32 if we can just look at this at the conclusions on comparison at p.45, paras 203 to 206.

33 Despite all the difficulties

1 “... the Commission has nevertheless drawn up a comparison of the official tariffs  
2 published by several European ports relating to their port charges vis-à-vis ferry  
3 operators. The detailed comparison is set out ...”

4 Then at para.205:

5 “The tables attached ... confirm that there are discrepancies in the different  
6 charging systems and in the repartition between the ship fee and the goods’ fee.”

7 But then at 206 they say:

8 “On the basis of this comparison, there is no evidence that the prices charged by  
9 HHAB to the ferry-operators at Helsingborg would stand out, in particular as  
10 compared to tariffs applied in other Swedish ports, but also in comparison with  
11 other ports, such as Calais and Dover ...”

12 Calais and Dover of course are in different Member States, which are of similar size in  
13 terms of numbers of passengers and cars. So the short point here is that the Commission  
14 well recognised the difficulty with doing a comparison but nonetheless did a comparison  
15 between Helsingborg and Dover and Calais and said, “You do not stand out and therefore not  
16 unfair by reference to competing ports”.

17 The next step in the analysis was then to go on to consider the question as to whether the  
18 port charges are unfair in themselves, and you see the heading “II.B.2.1.d)”. The way that  
19 the Commission did this can be picked up at p.48.

20 “Assessment by the Commission of Scandlines’ comments

21 “... an analysis of excessive or unfair pricing abuse must focus charged, and its  
22 relation to the *economic value* of the product. While a comparison of prices and  
23 costs, which reveals the profit margin of particular company may serve as a first  
24 step in such an analysis, this in itself cannot be conclusive as regards the existence  
25 of an abuse.

26 In line with what the Court has stated in paragraph 252 of the United Brands  
27 judgment, a distinction must be made between the assessment of the difference  
28 between the price and the production costs – the profit margin – and the  
29 assessment of whether the price is unfair.

30 At the end of section II.B.2.1.d), the Commission concluded that in any event,  
31 even if it were to be assumed that the profit margin of HHAB is high or even  
32 ‘excessive’, this would not be sufficient to conclude that the price charged bears no  
33 reasonable relation to the services provided.”

34 Then if we go to 221:

1 “The Commission does not exclude that the question whether a price is unfair may  
2 be assessed within a cost-plus framework which encompasses the respective  
3 relations between the production costs, the price (or profit margin) and the  
4 economic value of the product/service. However, in such an assessment, the  
5 economic value of the product/service cannot simply be determined by adding to  
6 the costs incurred in the provision of this product/service a profit margin which  
7 would be a pre-determined percentage of the production costs.”

8 That is very important, you are not looking at the extent of the over-charge or the excess.

9 Then they go on to say this:

10 “First, it should be recalled that there uncertainties in this case, as regards the  
11 precise determination of the incurred costs ...”

12 Pausing there, what is of particular interest in the *Scandlines* case is that it bears a striking  
13 resemblance to this case because most of the costs for ports were fixed costs and the  
14 variable costs were relatively small. It is similar to the water industry. That is one of the  
15 reasons, because they were fixed costs, that you had difficulties in terms of a cost allocation.  
16 I just want to show the Tribunal para.223 in the light of some of the comments that were  
17 made yesterday:

18 “Moreover, due to the fact that HHAB did not provide a realistic cost model for its  
19 pricing, the Commission had to refer to the data available in the audited financial  
20 reports.”

21 So there was, if you like, a lack of transparency in that case, but we will see that when the  
22 Commission comes to its conclusion it gives the benefit of the doubt to the dominant  
23 undertaking.

24 What is of interest at paras.223 and 224 is that the Commission is there saying that there are  
25 certain matters that we, the Commission, have not taken into account on the costs side that  
26 may then be relevant on the economic value.

27 That leads to the proposition that I say one derives from *Scandlines* and in fact *AttheRaces*,  
28 that when one is looking at economic value one is looking at non-cost factors. What one is  
29 looking at is factors that have not been taken into account in stage one. That is what is  
30 meant by “non-cost factors”, and that is obviously of particular importance in relation, for  
31 example, to the back-up supply because if the Tribunal were to conclude that is not to go  
32 into the cost bucket because it is not a cost factor, then, in my submission, it must go into  
33 the economic value bucket.

1 THE CHAIRMAN: Is there not another way of looking at it. What one is looking at in these  
2 other matters are non-cost factors. Back-up supply is something which could be costed.  
3 What you are looking at is something which ----

4 MR. VAJDA: No, back-up supply is either a cost factor or it is not a cost factor. We say it is a  
5 cost factor. That is what the authorities. If the Tribunal were to take the view, no, it is not a  
6 cost factor, then it must go into – there are only two buckets, there is the economic value  
7 bucket and the cost factor bucket, and it must go in one or other of the buckets. That is  
8 what we are saying.

9 PROFESSOR PICKERING: Mr. Vajda, economic value I think has to be understood in the first  
10 instance to include cost factors, does it not, but I take your point that those are considered at  
11 stage one. The wider aspects of economic value which may be considered in stage two are  
12 perhaps those that reflect a customer's willingness to pay for a particular advantage or  
13 quality of a product or convenience, and so on, which is not itself reflected in costs of  
14 production.

15 MR. VAJDA: I agree with that, absolutely.

16 PROFESSOR PICKERING: That is helpful.

17 MR. VAJDA: What I am saying is, and this is important, is that economic value covers all non-  
18 cost factors. It covers the cost factor that Professor Pickering has just so helpfully outlined,  
19 and it also covers factors that you do not take into account at stage one. I am completely *ad*  
20 *idem* with the Professor.

21 Then if we go to 225:

22 ‘ ... there is no information on what a reasonable profit margin should be ...  
23 insuperable difficulties in establishing valid benchmarks ...’

24 They go on to say that even if you look at the return on capital in Swedish industry:

25 ‘... provided it is made on a consistent basis, could in principle only be considered  
26 as an indication and not as sufficient evidence in itself in determining whether the  
27 port charges are unfair in themselves.’

28 Then the point which is really the point that Professor Pickering made, which is at 226:

29 ‘The determination of the economic value of the product/service should also take  
30 into account of other ...’

31 and the important word is the word “other” there:

32 ‘... other non-cost related factors, especially as regards the demand-side ...’

33 So what is seeing is that is an illustration, it is not exhaustive. It is exactly the point that  
34 Professor Pickering has picked up.

1 Then if we go to 232:

2 ***“Conclusion***

3 “In the present case, the economic value of the product/service can not simply be  
4 determined by adding to the approximate costs incurred in the provision of this  
5 product/service as assessed by the Commission, a profit margin which would be a  
6 pre-determined percentage of the production costs. The economic value must be  
7 determined with regards to the particular circumstances of the case and take into  
8 account also non-cost related factors such as ...”

9 Again, illustrative as a demand for the product or service.

10 At the next page the Commission then effectively looks at the points that were raised by  
11 Scandlines, which it then rejects. We can go to p.53 and at 241 the Commission made the  
12 point that Professor Pickering has made:

13 “... that the economic value of the product/service should also reflect the demand  
14 side features of this product/service. Scandlines acknowledges that the port of  
15 Helsingborg represents a value to Scandlines and its customers because of its  
16 unique location close to Elsinore. The Commission takes the view that this should  
17 be taken into account in the assessment of the economic value of the service  
18 provided HHAB and in its price.”

19 Then importantly at 243 it makes this comment in relation to dominance:

20 “The port of Helsingborg ...”

21 – we saw that it had a 100 per cent market share –

22 “... holds a dominant position on the relevant market ... However, the mere  
23 finding that a company holds a dominant position is not in itself recrimination.”

24 That is obviously important in the light of some of the submissions that Mr. Thompson  
25 made yesterday.

26 Then we come to what the Commission concluded:

27 “An abuse must be established, i.e. that a dominant undertaking is engaged in  
28 exclusionary and/or exploitative practices. To this end, the burden of proof is on  
29 the Commission to demonstrate, based on cogent evidence, the existence of such  
30 an abuse. In this respect, the ECJ stated in United Brands that ‘however unreliable  
31 the particulars supplied by [the dominant company]..., the fact remains that it is  
32 for the Commission to prove that [the dominant company] charged unfair prices’.  
33 In that particular case, the Court found that the basis for calculation adopted by the

1 Commission was open to criticism, and that any doubt must benefit the alleged  
2 infringer.”

3 That is effectively the approach of the Commission in this case.

4 “In the case at hand, despite an extensive analysis including an approximate  
5 calculation and allocation of HHAB’s costs based on the available information, the  
6 Commission considers that there is no sufficient evidence to establish that HHAB  
7 charges unfair/excessive prices that would constitute an abuse of dominant position  
8 within the meaning of Article 82 of the Treaty.”

9 If we could take up the written script, which I hope will speed things up, we derive a  
10 number of propositions from *Scandlines*. This is on p.5 of the written script. I think 1 to 5 I  
11 am not going to repeat orally because I have already made those points going through the  
12 case. Could I start at 6. In so far as there is any conflict between the propositions at 1 to 5  
13 and *Deutsche Post*, which was decided three years earlier, the propositions above prevail.  
14 We refer to our skeleton argument. What is important in this context, or the Tribunal may  
15 think it is important, is that both the Court of Appeal in *AtTheRaces* and indeed the learned  
16 authors of **Bellamy & Child** rely on *Scandlines* rather than *Deutsche Post*.

17 Can we just look at **Bellamy & Child** for a moment, which is at flag 15 of the authorities  
18 bundle, 10.106, p.986 of the extract:

19 “**The Commission’s approach: *Port of Helsingborg***. Since *United Brands*, the  
20 Commission has been reticent about taking decisions on ‘unfair prices’ outside the  
21 telecommunications sector of where the case involved price differentials which  
22 perpetuate market divisions.”

23 Although the authors do not in fact even cite *Deutsche Post* here, one might say that  
24 *Deutsche Post* is a single market case. The important point here is that the approach of the  
25 Commission is taken to be in the *Port of Helsingborg*. The *Port of Helsingborg* is how the  
26 court has described the *Scandlines* case. We say that *Scandlines* is now the leading case,  
27 and more than that it has been conditionally endorsed by the Court of Appeal in *AtTheRaces*,  
28 and therefore the approach, in my respectful submission, is now binding on the Tribunal.  
29 I come to point 7. You will recall that Mr. Thompson yesterday relied on nine factors at the  
30 beginning of the chapter on abuse. What we say is that what the Tribunal has to focus on is  
31 the issue of economic value, and so far as I can see none of the nine factors that Mr.  
32 Thompson relied on played any rule in the Commission’s analysis of economic value in the  
33 *Scandlines* case. What one is focusing on here is economic value. I can then go over the  
34 page to p.6 to deal with *AtTheRaces*. In view of the time, Madam Chairman, perhaps we

1 should just have it open at Tab 10. First, it fully endorses *Scandlines*, which I say is now  
2 binding on the Tribunal, and then it makes some helpful additional observations. The first  
3 one -which one really gets out of *Scandlines*, but they make it absolutely clear at para. 207 -  
4 is that,

5 “There is nothing in the Article or its jurisprudence to suggest that the index of abuse  
6 is the extent of departure from a cost plus criterion”.

7 We see at para. 209 that they say that nor is charging above cost-plus even a principle  
8 criteria for finding an abuse. That is the middle of para. 209 where they do not accept Mr.  
9 Hollander’s argument.

10 Then, importantly - and this is of particular importance, we say, in the present case - the  
11 Court of Appeal have made it absolutely clear at the bottom para. 2008,

12 “It seems to us that the most that a successful challenge under Article 82 can achieve  
13 in a case like this [and the present case is a commercial case as well] is a re-  
14 negotiation [well, that may be of particular resonance in this case because, of course,  
15 the one thing that there was not after the FAP was communicated was a negotiation]  
16 not a cost plus limit on prices, for whatever else Article 82 does [and we read for that  
17 Chapter II as well] it does not create a European system for determining prices”.

18 That is all I want to say about *AtTheRaces*.

19 The next, and last case, I need to say something briefly about is *Deutsche Post*. I say this -  
20 and again I am conscious of the time: insofar as it equates economic value to the cost of  
21 providing the service (and we give some of the paragraphs where we suggest that might be  
22 the case) it cannot survive *Scandlines* and *AtTheRaces*. Indeed, **Bellamy & Child** do not  
23 dissent from that. They do not in fact even suggest that you do not follow the *Scandlines*  
24 approach.

25 PROFESSOR PICKERING: Mr. Vajda, you do not follow the *Scandlines* approach on the  
26 assumption that there are what are often referred to as externalities to consider over and  
27 above the cost of provision. That is the point, is it not? If you do not have any non-cost  
28 factors that are appropriate to be taken into account then what *United Brands* in a rather  
29 limited fashion refers to as ‘the cost of production’ still applies as the basis for determining  
30 economic value, surely?

31 MR. VAJDA: No, because you are then effectively falling into the trap that the Court of Appeal  
32 found - which is that you are simply looking at it by reference to cost. You will not find a  
33 case where they are not non-cost factors. Every case will have non-cost factors. If you say,

1 “We are going to disregard them as a matter of fact”, you are then going to fall into the error  
2 of law that the Court of Appeal identified in *AtTheRaces*.

3 PROFESSOR PICKERING: Are you saying that every case necessarily generates appropriate  
4 non-cost practice to be taken into account?

5 MR. VAJDA: Yes. If you look at *Scandlines* you might think that any product that is going to be  
6 bought is going to be useful and have a value; people will want it, whether it is a banana,  
7 water, a court service. In the present case there are a whole heap of factors - some factors  
8 relied on by Mr. Thompson; some factors relied on by me - and in my respectful submission  
9 it would be an error of law for a tribunal to say, “We are simply, as a matter of principle  
10 going to disregard all non-cost factors”. As I say, you have two buckets - you have a costs  
11 bucket and an economic value bucket. It has to go in one or the other.

12 Returning to *Deutsche Post*, what we say is that it is essentially a single market case. The  
13 Chairman will well know that the Holy Grail of European competition law is effectively a  
14 single market. What it was was effectively the German post office stopping the British post  
15 office getting into the German market. We say that can be looked at, if you look at the order  
16 -- Again, because time prevents me from doing it, we are not going to, but if you look at the  
17 order that was made in Articles 1 and 2 of the decision, surcharging was just part of the  
18 conduct of obstructing the single market. We draw your attention to the fact that what the  
19 order does not say is what is a non-excessive price, which, of course, is wholly consistent  
20 with what the Court of Appeal said in *AtTheRaces* about Article 82 not being a price control  
21 system.

22 The Tribunal may have noticed - and if they have not, I draw it to their attention - that in  
23 fact the approach of the Commission in *Deutsche Post* was to take the domestic retail tariff,  
24 and you take a percentage off that for a comparable wholesale service. Well, if you apply  
25 that methodology in our case, that would mean that you start with a retail price to Shotton as  
26 a benchmark for the wholesale price to Albion. That is not a methodology that so far as I  
27 am aware has been suggested by Albion. A final, and small point: we say the reason that  
28 the profit margins were low in that case was that effectively the cost was processing and  
29 mailing of large volumes of bulk mail where probably most of the costs are operating costs,  
30 and that in *Scandlines* we can see that the costs are much higher. We give the figure in our  
31 skeleton of a 194 percent return on capital, which is the figure that *Scandlines* concludes was  
32 the profit that the company was making. The Commission did not reject that figure. It  
33 simply said, “Well, on an economic value basis, no unfairness”.

1 I now come - and I am very conscious of the time - to the last bit on Issue 2 - the application  
2 of the law to the facts of this case. A lot of this has been set out in writing, and obviously  
3 we fully maintain what we have said in writing. The Tribunal will read it. Unfair by  
4 comparison. There was no finding that it was unfair by comparison. We have made our  
5 point as to why we say the Authority should have looked at that. But, the bottom line is that  
6 it is not unfair by comparison.

7 The key question then in this case is: Could it be said to be unfair in itself? In looking at the  
8 factors that go into the economic value bucket and non-cost, we say that an important factor  
9 is the regulatory framework. The first point to make is that AAC pricing - that is to say,  
10 average pricing - was the approved way of pricing access charges in 2001. When I say 'not  
11 like bananas' that is a sort of code to myself - no disrespect to anybody here. It is simply to  
12 contrast this with, say, *United Brands* where, effectively, plainly if one is looking at the  
13 price of a banana, *United Brands* could not say, "Well, we're just going to look at the price  
14 of all the fruits that we sell". In water it is different because that was the methodology that  
15 Ofwat required my clients to adopt, and the Tribunal will recall the force with which Mr.  
16 Anderson sought to support that methodology, ultimately unsuccessfully before the  
17 Tribunal.

18 The second point that we make in relation to regulatory framework is that we will have seen  
19 from the evidence that the price was one that was subject to the Authority's approval. My  
20 clients were very anxious to ensure that this was approved by Ofwat. In the end, Ofwat  
21 said, "You should go away and negotiate". We saw that was happening in 2001. What then  
22 next happened was that there was then a complaint lodged almost simultaneously with  
23 Ofwat. Ofwat did not in fact take a decision on this until 2004. But, in the 2004 decision it  
24 approved the price. So, it plainly took the view that this was not out of line.

25 I come to (b). This where we have to focus again on the two buckets - economic value  
26 bucket and cost bucket. If there is to be de-averaging, and de-averaging is obviously what  
27 the Tribunal wanted - and we are looking at the matter now locally - we say that there  
28 should be de-averaging of risk as well. The point here, of course, is that we are dealing  
29 with non-potable customers where the risk is much higher because industry is subject to  
30 international competition, and you do not have the certainty that you have with domestic  
31 household customers that the company will be there. So, if you go to raise money to do the  
32 project in the City, you are going to require a higher rate of return because the project is  
33 inherently more risky.

1 Professor Pickering and Mr. Lewis will recall that this was a matter of some debate before  
2 the Tribunal in 2006, I think it was - what the cost of capital was. They will recall that the  
3 Tribunal rejected my client's submission that we should be entitled to a cost of capital of 20  
4 percent. The reason that we took the figure of 20 percent, you will recall, is that that was  
5 the rate of return that Albion said that it required for what was said to be a very risky  
6 project. If I can just give the Tribunal the reference to that, that is at Albion's notice of  
7 appeal at para. 207 and at Annexe 12, p.129, para. 100(d).

8 In fact, the Tribunal may recall that that was a figure higher than the figure that we  
9 ourselves suggested should be taken. Mr. Jones (Professor Pickering and Mr. Lewis will  
10 recall) asked for a figure of 17.5. The next figure, as it were, on cost of capital is the one  
11 that Europe Economics took (which is in the final report at 6.55) of 12.2. That was on a  
12 disaggregated basis. The Authority, in their subsequently calculation, gave us 11.1.

13 If we go to (b) of the little note, that is why we say those are the four rates I am referring to.  
14 If effectively what the Tribunal has said, "Well, this cost of capital - we're not going to give  
15 you that because we have to have the regulatory return of capital" -- We say that when one  
16 is looking at the economic value, there is no reason why, so far as the economic value is  
17 concerned, Dŵr Cymru should be allowed to earn less than Albion would be.

18 We have made the points in writing. I give the references. I also give a reference back to  
19 *Scandlines* where this point arises.

20 THE CHAIRMAN: I am coming into this new, of course. What the cost of capital to you is may  
21 be very different from what the cost of capital to Albion is because you are an established  
22 company. The risks are different. Investors would look very differently on you and what  
23 your return was than on Albion. If you were standing there and Albion was standing there,  
24 and I am looking to see who I invest in, my considerations are very different.

25 MR. VAJDA: Yes. You have the reflection of 20 percent and 17.5 percent ----

26 THE CHAIRMAN: I find it very difficult to see how your clients can say, "Well, I want the same  
27 return with Albion" - unless you are saying you are as risky a company as a start-up.

28 MR. VAJDA: No. But, what we are saying is that obviously when a bank lends money they will  
29 look at two things: they will look at the project -- If Tesco want to go on to the moon to put  
30 a supermarket there, they are going to have to pay a pretty high return ----

31 THE CHAIRMAN: Yes. But, they are also going to look at Tesco. If they are going to look at  
32 my bank account it is going to be very different.

33 MR. VAJDA: Obviously. That is why I say there are two factors - that you look at the project and  
34 you look at the person who is going to be doing the project. I take the point that the

1 Chairman has put to me - that certainly if one is looking at cost, when we were here in 2006  
2 we were not seeking to replicate the Albion rate. The figure that we relied on was 17.5  
3 percent. But, that was rejected by the Tribunal on the basis that we should effectively have -  
4 -- Our point is that the reason the regulatory rate is so low is because most of the business  
5 is to domestic customers, which is low risk. There is an element of cross-subsidy here  
6 because effectively, in relation to cost of capital the industrial ----

7 THE CHAIRMAN: I understand what you are saying.

8 MR. VAJDA: Exactly, and maybe I put the point ----

9 THE CHAIRMAN: I thought you said you wanted 20 per cent.

10 MR. VAJDA: You are right, I did say 20 per cent and perhaps on reflection 17.5 is a better  
11 starting point. When one is looking at economic value one is looking at the matter not just  
12 on cost – one is looking at cost but not cost exclusively. The Tribunal has the point that we  
13 should be given – if I can put in homely language – “credit” for the fact that if you are going  
14 to disaggregate we should be given a higher rate of return on what went in the cost bucket.

15 THE CHAIRMAN: You say it is inconsistent, if you are disaggregating then you ought to look at  
16 the project.

17 MR. VAJDA: Yes, yes, we have a sort of outstanding potential point of appeal on that in relation  
18 to the cost bucket, but I am not going to go into that, because that is water under the bridge.

19 THE CHAIRMAN: Even if you take that approach you also have to look at the fact that it is an  
20 established company rather than a start-up.

21 MR. VAJDA: Yes, I accept that, but one probably has to do some averaging – as Professor  
22 Pickering points out, quite a lot of these factors were looking at the demand side, so you are  
23 looking at it from the point of view of the customer. But I think whether one takes 17 per  
24 cent or even the Europe economics of 12.1 per cent, what I am saying is that one needs to  
25 disaggregate the risk.

26 PROFESSOR PICKERING: Do you distinguish, Mr. Vajda between the cost of capital and the  
27 target rate of return on the capital employed in a project?

28 MR. VAJDA: Can I come back to you on that, Professor Pickering because I want to press on. I  
29 am not ducking the question – well, I am ducking the question but I will come back  
30 (Laughter) – I will have a second bash.

31 PROFESSOR PICKERING: I understand.

32 THE CHAIRMAN: You are going to rise above the water soon.

1 MR. VAJDA: Yes, I have made my point in relation to back-up supply, this is point two in  
2 relation to other factors. It is effectively that if it comes out of the cost bucket, it should  
3 come into the economic value bucket, because it is plainly of value.

4 THE CHAIRMAN: It depends how you look at it because if you are looking at economic value  
5 the economic value I thought was made up of a cost bucket, and these other factors which  
6 are not part of cost. Therefore, maybe one is looking in dependently, or separately at what  
7 is in that cost bucket. I do not think it matters, but I cannot see how it moves over to the  
8 other side?

9 MR. VAJDA: No, because they would have two buckets, madam Chairman -----

10 THE CHAIRMAN: I understand that.

11 MR. VAJDA: -- and something is in one bucket or it is in another.

12 THE CHAIRMAN: If the reason it is not in the cost bucket is it is not part of what you are  
13 looking at as being supplied, and if that is right it does not go into the other bucket?

14 MR. VAJDA: It plainly is because there is no doubt that it is something that is required and is of  
15 value ----

16 THE CHAIRMAN: It may be required, but it is not part of the service which was being costed  
17 and priced for this purpose – or it may not be.

18 MR. VAJDA: We come back to the hypothetical ----

19 THE CHAIRMAN: Assuming.

20 MR. VAJDA: Even assuming that, the reality is that what the Tribunal is considering here is  
21 whether this price is excessive vis-à-vis Albion and there can be no dispute on the evidence  
22 that Albion would not be able to provide a common carriage service without this additional  
23 back-up, so it is of value to Albion in exactly the same way that the location at the port was  
24 of value to Scandlines; that is the point I am making.

25 Mr. Thompson made a few points in relation to margin squeeze saying that it is a factor  
26 which you should take into account, and we have dealt with that in the reply skeleton so I  
27 do not want to take time up on that now.

28 That brings me then to the overall conclusion on unfairness in itself. We say, and this is  
29 obviously in addition to the point we have in writing, look at the regulatory context in 2001.  
30 Secondly, you will need to look plainly at all three methodologies in the round. We come  
31 back to LRIC, and this is a point which we make in relation to back-up. LRIC excludes  
32 back-up but LRIC and the other figures are pretty close to LRIC, which include back-up and  
33 even in relation to LRIC, and this is the point that we make under back-up, the Authority

1 recognise that in relation to LRIC, it excluded that cost but it accepted that Dŵr Cymru  
2 would be entitled to charge that and we give the references in the final report.  
3 The third factor is the uncertainty factor. The uncertainty factor is a point which is  
4 obviously of particular importance where you are dealing with large amounts of fixed costs,  
5 that is the point that Commission made in *Scandlines* and then the burden of proof point.  
6 I apologise that I have overrun my time. What I would like to do is pick up one small point  
7 that Mr. Thompson made yesterday. There are a number of much smaller points about the  
8 decline in value of MEAs and that sort of thing. What I propose to do is to listen to what  
9 Mr. Anderson says and if there is anything at the end that we would wish to add, if we  
10 would be allowed to do that, possibly just by putting in a short note in writing. They are  
11 very much subsidiary points and I had not wanted to take time up orally.  
12 The last point I want to deal with orally is the alleged 87 per cent gross margin which has  
13 been relied on by Albion, and appears at para.6 of the main judgment. It is important to  
14 understand that the gross margin is merely the ratio of all those elements that make up the  
15 retail price which is 27.4p/m<sup>3</sup> other than the water resource element. So what it is saying is  
16 that 87 per cent is things other than water. But that in itself does not show anything; all it  
17 shows is that 13 per cent of the retail prices are accounted for by the cost of the water, and  
18 87 per cent is the cost of everything else: distribution treatment, associated costs, back-up,  
19 return on capital, etc. It is like saying that the gross margin, for example, you buy a banana  
20 at Tesco down the road for £1, and in fact, in Tesco bought it in the Windward Islands for  
21 10p. What you have to look at, and what the Tribunal has rightly focused on is what  
22 happens in the intermediate stages and whether that can be justified. So to say that we have  
23 a gross margin of 87 per cent and that is somehow thrown out as a bit of, no doubt prejudice  
24 against us, with respect, does not assist. In my respectful submission it merely confuses,  
25 because the question is whether that 87 per cent is or is not justified and that is precisely  
26 the task that this Tribunal has engaged on.  
27 In relation to Professor Pickering if I have the benefit of the luncheon adjournment and then  
28 I can deal with his question after lunch.

29 THE CHAIRMAN: Have you finished?

30 MR. VAJDA: Yes, subject to that.

31 THE CHAIRMAN: Yes, so we will rise for five minutes, and then Professor Pickering has a  
32 number of questions to ask to you.

33 MR. VAJDA: It might be of assistance if Professor Pickering were able to give them to me now.

34 THE CHAIRMAN: I do not think that is possible because he has not got them written down.

1 PROFESSOR PICKERING: I think we will be all right.

2 THE CHAIRMAN: I had thought of that, but it is not going to work and it is just going to delay,  
3 so I think if we rise now.

4 MR. RANDOLPH: Madam, just before we rise, I have had an opportunity of discussing matters  
5 with Mr. Anderson and he very kindly agreed – obviously subject to your permission – for  
6 me to go after Mr. Vajda – shortly, 20, 25 minutes depending on questions from the  
7 Tribunal or it may be much shorter than that – and then Mr. Anderson can run through and  
8 Mr. Thompson can have an opportunity to deal with all the matters.

9 THE CHAIRMAN: Are you happy with that?

10 MR. THOMPSON: Subject to issues of timing. I do think Mr. Anderson’s contribution is likely  
11 to be valuable, I do not want it to be.

12 THE CHAIRMAN: I know, I am worried about that – we are not going to finish this afternoon.

13 MR. RANDOLPH: Madam, I did say, when asked for my time estimate, that it would be  
14 maximum 30 minutes. I do not think we are going to get anywhere near that.

15 THE CHAIRMAN: You are not going to be repetitive.

16 MR. RANDOLPH: I would hope I am never repetitive, madam, but I certainly will not be  
17 repetitive this time – if I ever have been in the past. No, I will not, I will be as short as I  
18 can, but I always said I was going to be maximum 30 minutes.

19 THE CHAIRMAN: You said 20 now.

20 MR. RANDOLPH: Absolutely, I have said between 20 and 30. I will be as short as I possibly  
21 can. The Tribunal has said they might like to ask me some questions, but Mr. Anderson is in  
22 favour. I am obviously aware that I am a bit player in this and I do not want to take up any  
23 more time.

24 THE CHAIRMAN: Right. It will have to be five past by that clock.

25 (Short break)

26 THE CHAIRMAN: Mr. Vajda, I think Professor Pickering is going to ask some questions.

27 PROFESSOR PICKERING: Mr. Vajda, in one of your recent submissions to us, you developed  
28 an interesting analysis based on walk-away costs or walk-away prices – do you remember?

29 MR. VAJDA: Perhaps you could show me.

30 PROFESSOR PICKERING: Do you not recall talking about walk-away costs?

31 MR. VAJDA: It would be helpful if you could ----

32 PROFESSOR PICKERING: Maybe Mr. Bailey can check that while I go on and ask one or two  
33 other questions. At various points in this case there has been reference to the role of United

1 Utilities as Dŵr Cymru’s agent, your “operating partner”, Mr. Jones describes United  
2 Utilities as in his third witness statement, para.71. I do have these references.

3 MR. VAJDA: I am just writing them down to keep stock.

4 PROFESSOR PICKERING: That is para.71 of the 10<sup>th</sup> May 2006 statement. In her witness  
5 statement dated 19<sup>th</sup> October 2004 Miss Cross sets out at some length and very clearly the  
6 way in which the operation of the Ashgrove system is out-sourced to United Utilities  
7 Operating Services, I think the full title of. One of the judgments made reference to this and  
8 there was a passing reference to it in directions hearing on 24<sup>th</sup> October 2006.

9 That prompts in my mind the question, whose costs are we actually debating here? Are  
10 these costs provided by United Utilities or are they your assumption about the costs that  
11 United Utilities have incurred? How many profit margins are we looking at here?

12 MR. VAJDA: I think I will deal with that after the adjournment, if I may. I have made a careful  
13 note of that.

14 PROFESSOR PICKERING: Thank you. The next question then is this: as I understand it, the  
15 Ashgrove system – and I am not sure whether it is the whole system or just the water  
16 treatment works – is described as a “costs centre”. Can you tell me which it is, which is the  
17 costs centre? Is it the whole system? It is the whole system? You have a colleague behind  
18 you who will tell you?

19 MR. VAJDA: Just the works, I am told.

20 PROFESSOR PICKERING: Just the works. Are costs analyses produced for that costs centre  
21 that is just the water treatment works?

22 MR. VAJDA: We did go into this in, I think it was, Chris Jones’ third witness statement in terms  
23 of the costs.

24 PROFESSOR PICKERING: Just remind me, do we have a costs centre analysis for that costs  
25 centre? You are saying it is in Jones witness statement three.

26 MR. VAJDA: We do not, because – and I will be corrected if I am wrong – the way that the  
27 regulatory accounts are done is that they are done on a costs centre by costs centre basis.  
28 As I understood it, what the Tribunal asked for after its interim judgment was this question  
29 of the stand-alone costs. It was in seeking to answer that that evidence was supplied by my  
30 client in relation to that. From memory it was dealt with in Chris Jones three, but maybe the  
31 best thing is that I will come back to that after the adjournment.

32 PROFESSOR PICKERING: The inference that one might draw from what you have just said,  
33 Mr. Vajda, is that it is the regulatory processes that determines and drives the whole

1 management and management accounting arrangements within the business organisation  
2 that is Dŵr Cymru.

3 MR. VAJDA: Certainly again I will be corrected if I am wrong, but the way that Dŵr Cymru has  
4 operated prior to these proceedings is on the basis of its regulatory accounts, but what  
5 effectively happened, as I said yesterday, is that the Tribunal decided to break the regulatory  
6 mould which has meant that what the Tribunal has asked both the Authority to do, and  
7 indeed what Chris Jones sought to do, was to look at the matter in a way which was, if I can  
8 put it like this, more akin to a supermarket -- Perhaps supermarkets are a bad example  
9 because they may be about to be regulated! But, an unregulated company. But, rather than  
10 giving a wrong answer I think, again, this is something I will take instructions on and come  
11 back.

12 THE CHAIRMAN: I find it a little bit confusing - your answer to that, insofar as you have given  
13 an answer - because my experience of how companies work is that there are commercial  
14 accounts -- there are tax accounts -- and there are, if you have some requirement to a  
15 regulatory, regulatory accounts. What the company is doing is working commercially. I  
16 know this is 'not for profit' but that probably does not make any difference. It is working  
17 commercially. It must have the first line, which is how it is going to work commercially. It  
18 then justifies, or does not justify that, having regard to any regulation which -- It says, "I'd  
19 like to do X but I can't do X because of Y". That is a second layer. Then, the third layer is  
20 tax.

21 MR. VAJDA: I think probably what you have in mind, Madam Chairman, is what might be  
22 known as management accounts.

23 THE CHAIRMAN: Yes. Absolutely.

24 MR. VAJDA: Yes. Again, rather than giving the Tribunal a wrong answer, can I take  
25 instructions? My understanding was that there were no management accounts in the form  
26 that Professor Pickering was looking at. Let me give the correct answer at two o'clock.

27 THE CHAIRMAN: That raises an interesting question as to how they looked at the Ashgrove  
28 system. I am not sure we should go into that. But, if management accounts did not look at  
29 Ashgrove as --

30 MR. VAJDA: It is common ground that the price was calculated on an AAC basis.

31 THE CHAIRMAN: Yes. They did not look at it, no.

32 PROFESSOR PICKERING: You were talking earlier this morning about the fixed costs  
33 identifiable in the Scandlines case, and suggesting that in the water industry there are  
34 certain similarities - not only that ports require water, but there are, I would suggest, sunk

1 costs, which may well be fixed costs, of course. But, would you agree that this is what we  
2 are really talking about analytically? These are costs that have been incurred at some time  
3 in the past. Yes?

4 MR. VAJDA: Yes.

5 PROFESSOR PICKERING: Sunk costs, economically-speaking, are treated as bygones. It does  
6 not necessarily follow, certainly if there is not an anticipation of a requirement to replace  
7 the capital asset in new sunk costs, then those bygones would not necessarily be included in  
8 a pricing decision.

9 MR. VAJDA: I agree. Looking at the moment not in terms of domestic price but in relation to,  
10 say, Article 82, I would agree with that. But, I think the important word that you used,  
11 Professor, was the word 'necessarily'.

12 PROFESSOR PICKERING: I use that deliberately.

13 MR. VAJDA: This is effectively one of the points which the Commission made in *Scandlines*. If  
14 you say, "We're going to exclude them because they are sunk costs, and therefore they are  
15 not costs" - in my terminology they are not in the costs bucket - you then have to take  
16 account of them in the economic value bucket.

17 PROFESSOR PICKERING: You have to decide what you do about them.

18 MR. VAJDA: You have to decide what you do, yes.

19 PROFESSOR PICKERING: Just as with stranded assets.

20 MR. VAJDA: Yes, that is right. As I said, if you take the view that, "Because those costs have  
21 been sunk we are not going to take them into account as [if I can put it this way] cost of  
22 production" -- Obviously, there is a judgment to be made there. But, then they do not go out  
23 of the picture altogether. You then have to make an assessment of how they come in on  
24 economic value.

25 PROFESSOR PICKERING: Certainly they are not a cost of production in the sense of a direct or  
26 an operating cost, are they?

27 MR. VAJDA: No.

28 PROFESSOR PICKERING: Staying with the question of costs and the determination of costs,  
29 would you agree with me that in the efforts that have been made to produce relevant cost  
30 information and cost justifications there has necessarily been a degree of fluidity in terms of  
31 the choice of denominator - for example, in the allocation of expenditure, or revenues,  
32 between potable and non-potable water, then there is a choice to be made between the use  
33 of a volume basis or a revenue basis? In calculating costs of water per cubic metre then  
34 there is a choice to be made between calculating that on the basis of the actual volume of

1 throughput or the actual volume of full capacity utilisation. It seems to me, taking the latter  
2 one first, that you have tended to use actual throughput which, of course, is more variable  
3 year by year anyway than full capacity. I suppose from an economic point of view one  
4 would say that if that is the basis on which that is done, then that removes the incentive to  
5 maximise the capacity utilisation because if you based it on full capacity then the price, or  
6 the cost per cubic metre, would be lower. Do you wish to comment on that reflection?

7 MR. VAJDA: Yes. My first comment is that that is primarily, I think, a matter for the Authority  
8 because they were the ones who were tasked by this. Indeed, this comes back to the point  
9 that I was making yesterday - that in looking at the question of cost there are a number of  
10 judgments that have to be made. These are the points on which the Tribunal said, "We  
11 cannot do it. We are going to give it to the Authority. The Authority is the regulator for the  
12 water industry and they are the people who have to make these sorts of judgment". But, I  
13 agree that there is a degree of fluidity.

14 PROFESSOR PICKERING: There is a degree of benefit to the incumbent undertaker if one uses  
15 actual throughput rather than capacity in that case.

16 MR. VAJDA: I am not sure I would accept that, but perhaps I can come back on that.

17 PROFESSOR PICKERING: I would have thought it was a fairly simple mathematical  
18 observation. So far as the choice between volume and revenue is concerned, then would  
19 you agree with me that because non-potable water tends to have a lower value than potable  
20 water, then to calculate that on the basis of volume again would have an uplifting effect as  
21 compared with a calculation based on a distribution by revenue?

22 MR. VAJDA: If it is simply a matter of arithmetic, yes. But, these are all points, with respect,  
23 which are matters that lie within the expertise and judgment of the Authority. The Tribunal  
24 did not ask Dŵr Cymru to come up with this - they asked the Authority to do so. The  
25 Authority has made judgment on the sorts of points which you have raised, and it has not  
26 hung its hat simply on one methodology - it has adopted three.

27 PROFESSOR PICKERING: No doubt Mr. Anderson may want to offer some thoughts on those  
28 points this afternoon. That is helpful. Thank you. You will be glad to know I am getting  
29 towards the end!

30 MR. VAJDA: It is always a pleasure appearing here in the Tribunal and dealing with the  
31 questions I can. I am more than happy to be here until half past four, but I suspect Mr.  
32 Thompson will not be very happy!

33 PROFESSOR PICKERING: I think neither you, nor I would gain many plaudits if we were still  
34 debating these things. I am glad you enjoy the interchange, Mr. Vajda.

1 Your new tariff for non-potable water. You have a discount structure. That discount  
2 structure stops at 1,000 megalitres per annum (I think it is). Now, the off-take by Shotton  
3 Paper through its inset appointee -- inset supplier, Albion, is 6,700 megalitres per year. I  
4 imagine that there is at least one other non-potable customers whose off-take would be  
5 considerably above the point at which the cut-off applies on discounts. Do you, or your  
6 clients, have any comment as to why the discount structure did not continue?

7 MR. VAJDA: I will have to take instruction on that.

8 PROFESSOR PICKERING: Let us turn to the question of non-potable distribution and treatment  
9 system. Particularly we can perhaps focus on the Ashgrove system where it appears to be a  
10 matter of agreement that the life of the system is over 100 years, and we are fifty-odd years  
11 into that at the moment. So, there is another 50 years to go if you take 120 years; as Dŵr  
12 Cymru and the Authority have used them, there is seventy-odd years to go; and if we go up  
13 to the 180 that Mr. Thompson was arguing, then there is over one hundred years to go. At  
14 an earlier hearing we were told that this is treated on the basis of, effectively, a repayment  
15 mortgage . When does that mortgage get fully paid off?

16 MR. VAJDA: I have made a note of the question. I shall provide an answer.

17 PROFESSOR PICKERING: What is the depreciation arrangement? I assume it is some sort of a  
18 straight line depreciation. Again, I would like to know over how many years, if possible,  
19 please. Continuing on on that, could I just ask you about tax rates? As I understand it, a tax  
20 rate of 30 percent has been assumed in relation to calculations of the nominal cost of  
21 capital. But, according to the 2004 price determination by the Authority - and I believe  
22 these are five yearly bases, and so this is the most recent one - the Authority states that in  
23 1995 the tax rate in the water industry was 2 percent, and that as a result of a change in  
24 Inland Revenue/HMRC policy, that is now increasing and is likely to rise by the end of this  
25 decade to about 26 percent. Could I ask you what tax rate has been assumed in your  
26 calculations and submissions to the Authority in relation to this particular case, please?  
27 Again, you may want to come back on that, do you?

28 MR. VAJDA: Yes. Well I suspect it may be sensible, in view of the time pressure, that we deal  
29 with these possibly in writing.

30 THE CHAIRMAN: That is what I was thinking.

31 MR. VAJDA: Because tax rates is not something, so far as I am aware, has come up in this  
32 hearing before and I would suggest, madam Chairman – I will take instructions from my  
33 client – that that is probably the most expeditious way of dealing with this.

1 PROFESSOR PICKERING: I am content, because I recognise that I am asking for information  
2 which, if you do not have immediately to hand it is unreasonable to expect a guesstimation  
3 on.

4 THE CHAIRMAN: The only difficulty about that is if these are matters which other people want  
5 to address. We are then going to be getting in to an exchange of correspondence and then it  
6 becomes completely out of hand. Maybe the first stage is for you to produce your answers  
7 in writing; at that stage it may be that instead of having a lot of correspondence ----

8 MR. VAJDA: I will certainly take instructions over the adjournment and then maybe if and  
9 insofar as one is able to do it and there is time to do anything orally today we will; if there is  
10 not time we will put it in writing.

11 THE CHAIRMAN: These are matters which relate to the criticisms which have been made of the  
12 report by Albion, so they need to be ----

13 MR. VAJDA: I think these are just matters that – yes.

14 PROFESSOR PICKERING: Just going back to my first question ----

15 MR. VAJDA: I have made a note of your question.

16 PROFESSOR PICKERING: 13<sup>th</sup> November 2007, your letter to Dr. Bryan and you talk about a  
17 “walk-away” price and my question is what would your walk-away price be for your supply  
18 to Albion, i.e. the price below which you would not supply? The reason for that – the  
19 economic debate on this which undoubtedly is reflected in this letter is, as we recognise,  
20 that under certain circumstances and where you have a portfolio of activities for example,  
21 then the first priority is to ensure that you cover your direct costs, and probably then you  
22 hope that you will obtain some sort of contribution to corporate overheads. That is how I  
23 interpret your client’s treatment of the costs, of the walk-away price, and I think therefore it  
24 would be very helpful to know what actual figure you would have in mind.

25 MR. VAJDA: I am grateful, Professor, I have made a careful note of that.

26 PROFESSOR PICKERING: We have not been able to have much of an exchange, Mr. Vajda,  
27 but I look forward to what you are able to tell us about that.

28 MR. VAJDA: Yes, well certainly, I mean these are essentially your quest for information which  
29 we will supply to the Tribunal.

30 PROFESSOR PICKERING: Thank you.

31 MR. ANDERSON: Before United Utilities begins, I got the impression a number of those  
32 questions, at least if the question was not directed at the Authority the answer may well be  
33 that it should have been directed at the Authority, and I was wondering that my response  
34 might well be very similar to Mr. Vajda’s response if I am presented with a number of

1 technical questions of that kind. I just wondered if Professor Pickering had any particular  
2 points he would like the Authority to consider, otherwise any questions of that kind may  
3 sensibly be dealt with in writing.

4 PROFESSOR PICKERING: Madam, I am very grateful to Mr. Anderson for raising this and I  
5 would assure him, and indeed Mr. Vajda that I have tried to be reflective on where  
6 particular questions are directed, and if allowed by you, madam Chairman, I have some  
7 questions for Mr. Anderson; there are some which are very similar but there are others that  
8 reflect my perception of where the division of labour would apply. You will also  
9 understand, of course, that through a presentation of your case then other things may occur,  
10 and indeed some things may not need to be raised.

11 MR. ANDERSON: Of course.

12 PROFESSOR PICKERING: If that is helpful, I will gladly do so.

13 MR. ANDERSON: The point was simply whether there was anything in particular you would  
14 like me to be dealing with this afternoon and, if so, it might be sensible for that to be raised  
15 with me now rather than ----

16 PROFESSOR PICKERING: Well I thought you were asking that it could be raised with you at  
17 lunch time ----

18 THE CHAIRMAN: No.

19 PROFESSOR PICKERING: Well could we have until lunch time to do that so that I can reflect  
20 upon what I had thought of raising with you in the next 20 minutes.

21 MR. ANDERSON: When you say “until lunch time” it depends whether you mean ----

22 PROFESSOR PICKERING: Until 1 o’clock.

23 MR. ANDERSON: Of course, of course, I am entirely in your hands.

24 PROFESSOR PICKERING: Is that acceptable.

25 THE CHAIRMAN: Yes.

26 MR. RANDOLPH: Professor Pickering can multi-task by listening to me at the same time.

27 (Laughter)

28 PROFESSOR PICKERING: Indeed.

29 MR. RANDOLPH: A short point before I begin, on the burden of proof. Madam, you mentioned  
30 the *JJB* case. There is the recent case, I am sure you have seen it in the High Court,  
31 *Cheshire Borough Council v Arriva* – it is in the most recent competition law reports. Mr.  
32 Justice Rimer makes some rather useful points on that as well.

33 THE CHAIRMAN: There is also the Court of Appeal – I forget what the case is called – where  
34 in the First Instance there was an appeal from Mr. Justice Mumby, and *JJB* was cited.

1 MR. RANDOLPH: Yes, they all go in the same way. Madam, there is only one point I want to  
2 deal with, and it can be seen at para 27 of our skeleton, and it is that Albion *qua* competitor  
3 cannot rely on an alleged abuse of excessive pricing because that is an exploitative abuse.  
4 The answer we get to that – we go yesterday afternoon – was “Ah hah! I can get out of that  
5 because I am a customer, I am not a competitor”. Mr. Thompson kindly told me that Albion  
6 is apparently Dŵr Cymru’s second largest customer for that.

7 The question for this Tribunal, and it is a matter of law, is whether an alleged victim of an  
8 anti-competitive abuse can be both a customer and a competitor at the same time. If it is  
9 Mr. Thompson’s case that for all matters his client is a customer then the margin squeeze  
10 case goes by definition because margin squeezes – we do not need to go through it, the  
11 Tribunal has already looked at it, it is set out in my skeleton – are aimed at competitors,  
12 looking at competitors. Therefore, as I say, if Mr. Thompson were putting forward the case  
13 that he is, for the purpose of this case, in the round only a customer – or his client is – then  
14 he would have no jurisdiction to argue that his client was the subject of a margin squeeze. I  
15 assume that that is not his case and that his case is that he is both at one and the same time,  
16 a customer and a competitor.

17 I am not going to go to the main Judgment of this Tribunal, but I would give you the  
18 following paragraph numbers where it can be seen, I would submit, that the Tribunal has  
19 approached this case on the basis that it is Shotton, not Albion that is, in fact, the customer.  
20 Those paragraphs are the following: paras. 7, 11, 213, 293, 294, 295, 299, 302 and 305.  
21 In the further Judgment (18<sup>th</sup> December 2006) there are just three paragraphs to be looked  
22 at, paras.97, 98 and 117, where the Tribunal was looking at the issue of the relevant market,  
23 which is obviously key to the issue of dominance, and thereafter abuse, and that was fixed  
24 on the basis of Shotton and CORUS being customers. So we say, as a matter of fact, that  
25 actually the Tribunal has approached this correctly, it has decided that the  
26 customers/consumers are Shotton and CORUS and that in fact the position is that Albion,  
27 as it has always said it was, was a competitor. Professor Pickering has made comments  
28 during the course of the case about the need to bring competition into this industry, and has  
29 raised questions – indeed, the previous President has made similar points – and it has  
30 always been treated on that basis.

31 If Albion (Mr. Thompson) is to suggest that actually it can be a competitor, which it clearly  
32 is – or clearly says it is – for the purpose of the margin squeeze, and it is a customer for the  
33 purpose of excessive prices. Mr. Thompson does not seem to demur from my general  
34 proposition which is for an excessive price abuse to be made out it cannot be with regard to

1 a competitor because it is an exploitative abuse rather than an exclusionary abuse. That  
2 does not seem to be denied.

3 If Mr. Thompson is to say that, then he must show some basis for it, we would suggest.  
4 There is nothing that I have managed to find in any of the authorities that goes to that,  
5 where an alleged abused person, an alleged victim is wearing two hats. What you do have  
6 are two cases in the bundle where you have two different types of abuse, one exclusionary,  
7 on exploitative alleged in the same case – one is *Napp* and the other is *Attheraces*. *Napp* is  
8 very simple to analyse by virtue of the fact that the victims for the two different types of  
9 abuse were different. You had the community segment and you had the hospital segment –  
10 one was exploitative and one was exclusionary; absolutely no problem with that.

11 In terms of *Attheraces* again there was one single customer in that case. In terms of the  
12 pricing issue and the exclusionary abuse it was effectively a refusal to supply. Normally a  
13 refusal to supply being an exclusionary abuse would be horizontal – in other words you are  
14 looking at potential competitors.

15 Obviously in a refusal to supply one is looking at a vertical situation – you have the holder  
16 of the essential facility, you have the person downstream who cannot access that at the  
17 relevant price or at all. So as you know again no particular problem where you have the  
18 customer in *Attheraces* alleging that there has been an abuse of a dominant position by  
19 virtue of a failure to supply by an operator operating an essential facility, that makes  
20 complete sense.

21 Indeed, Mr. Justice Etherton made it clear that although refusals to supply generally apply,  
22 *qua* exclusionary abuse, to competitors they can apply to non-competitors, to customers.  
23 We pick that up at para.112 of the Court of Appeal’s Judgment, which is just a passing note  
24 to what Mr. Justice Etherton found at First Instance. That did not seem to be part of the  
25 appeal going through, so it was just accepted that in that particular case, and one can  
26 understand why and it was an essential facility case; the customer could allege an abuse, an  
27 exclusionary abuse which would not normally be open to it – that is fine, I do not have any  
28 problem with that. Here, Mr. Thompson has the problem because he cannot rely on the  
29 essential facilities’ argument any more, this Tribunal is *functus* on that point by virtue of the  
30 fact, as pointed out in my submissions, it found that it did not need to delve into that. What  
31 it did was quash the decision of the authority as to the finding it made with regard to  
32 essential facility, but it did not insert a new one. It said “We do not need to deal with this”.  
33 That could have been the subject of an appeal; it was not. So we are left where we are, and  
34 it would have been perfectly permissible I would suggest – whether it was made out or not

1 is a completely different point – for Albion to progress its case on the basis of margin  
2 squeeze and essential facilities, which are not very different. All I say, and it is a very  
3 simple point, is that in this particular circumstance in this case Mr. Thompson is not able to  
4 rely on excessive pricing by virtue of the fact that there is simply no authority which sets  
5 out the possibility for a victim who is relying on both an exclusionary and an exploitative  
6 abuse to put forward those positions where the main argument, if you will, relates to an  
7 exclusionary abuse – in this case margin squeeze – where he has put that forward and the  
8 Tribunal has found that, and they want to add on the argument with regard to exploitative  
9 abuse, i.e. excessive pricing. There is no authority that in such a circumstance one can be  
10 both competitor and customer. Indeed, in *Attheraces*, which we have just looked at, there  
11 was an identity of victims – the victim did not change – depending on what the abuse was.  
12 Here, and this is the unique factor, the victim changes. The legal identity of the victim  
13 changes depending on which abuse is being put forward. All I am saying is that, in our  
14 respectful submission, we do not think that, as a matter of EC law or indeed UK  
15 competition law which mirrors EC law in this respect, is allowable and there is certainly no  
16 authority to that extent.

17 THE CHAIRMAN: There is no authority though that says it is not allowable?

18 MR. RANDOLPH: No, madam, there is not.

19 THE CHAIRMAN: It is a question that has not come up before.

20 MR. RANDOLPH: It certainly has not come up for decision, but, as I said, at para.112 of

21 *Attheraces* Mr. Justice Etherton did make the point the other way round. I would say that  
22 that is understandable given the particularities of that case, and it did not concern a victim  
23 whose identity changed depending on the abuse. It was all the same, the customer.

24 PROFESSOR PICKERING: This, I have to say, I find a surprising argument. We have had 50  
25 odd years of competition policy in the UK, and I am not going to cite you cases, where the  
26 Monopolies Commission would have dealt with such issues which certainly, so far as I am  
27 aware, were not subject to judicial review. You seems to be saying that unless there has  
28 been a decided case this court cannot operate what I assume you would say is a rule of  
29 reason.

30 MR. RANDOLPH: I am not saying that at all, Professor Pickering.

31 PROFESSOR PICKERING: That is what I hear you saying.

32 MR. RANDOLPH: I am sorry, I do apologise, I did not put it clearly enough. I am not saying  
33 that, I am saying that the Tribunal has got to make up its own mind obviously. There is  
34 nothing in the authorities to assist Mr. Thompson. It may well be that the Tribunal, looking

1 at this in the round, looking at it on a legal basis, can say, “Mr. Randolph put his  
2 submissions, we do not accept those submissions for the following reasons”. All I am  
3 saying is that there is nothing to assist the Tribunal which would assist Mr. Thompson’s  
4 argument, which is that he can be both competitor and customer at the same time.

5 THE CHAIRMAN: We will have to decide that.

6 MR. RANDOLPH: That is my only point on that sub-issue.

7 THE CHAIRMAN: You have raised the issue as to whether you can be a competitor and a  
8 customer at the same time and we will have to decide that.

9 MR. RANDOLPH: Thank you, I am most grateful.

10 THE CHAIRMAN: Thank you very much, and you did it well in your time.

11 PROFESSOR PICKERING: Mr. Anderson, would you like me to tell you what is in my mind at  
12 the moment?

13 MR. ANDERSON: I would be more likely to be able to help you this afternoon if you did,  
14 Professor.

15 PROFESSOR PICKERING: I think that so far as the Authority is concerned, the identification of  
16 non-potable costs, whether in relation to potable costs or to the total costs of water – in  
17 other words, what is the ratio based upon and is it a consistent approach – is one matter. I  
18 have raised with Mr. Vajda, and I think it is pertinent to you as well and it flows on from  
19 that, that the question of the use of cost allocations based on volume rather than revenue is  
20 something that we might want to pick up.

21 I think also that I would hope to have a discussion with you about one’s understanding of  
22 the cost of capital, and I do not want to take time now but perhaps I should explain what I  
23 would want to explore with you. The cost of capital is normally understood in a regulated  
24 industry to reflect normal profits, the opportunity cost in relation to alternative use of the  
25 capital, and so therefore I would be interested to know how you would justify a figure that  
26 was higher in this case than the appropriate opportunity cost of capital, and why, given that,  
27 you would then, so far as I can from the work schedules, allow the addition of a return on  
28 capital employed based on MEAV. That seems to me to be adding further to it.

29 You would probably also want to comment on the point that I raised about whose costs we  
30 are actually measuring and the double-margin concern that is there.

31 I am also aware that in your final report the Authority makes no reference to the view that  
32 the Tribunal gave by way of a steer on the range of treatment costs. I would have thought,  
33 even if you felt that that was not appropriate or was now wrong, you would actually have  
34 hooked it back on to that.

1 I would have raised a point about how you were satisfied that we were dealing with an  
2 efficient organisation, which is the criterion for price approval, and perhaps I will stop  
3 there.

4 MR. ANDERSON: I will do my best over the short adjournment, but I cannot guarantee that the  
5 notes will be very long.

6 PROFESSOR PICKERING: I understand.

7 THE CHAIRMAN: Do you want to start now, or do you want to start at two o'clock?

8 MR. ANDERSON: I am entirely in your hands, Madam Chairman.

9 THE CHAIRMAN: It is probably better to start at two o'clock. We will start at two o'clock.  
10 Thank you all very much.

11 (Adjourned for a short time)

12 MR. ANDERSON: Madam Chairman, members of the Tribunal, could I start by saying that we  
13 do not accept the criticisms that have been levelled against us, in particular in the last two  
14 paragraphs of my learned friend's reply skeleton. The Authority takes its responsibilities as  
15 sector regulator very seriously, and is actively engaged in promoting competition where  
16 appropriate. More particularly, it has approached this referred work in a comprehensive and  
17 detailed manner. It has not been an easy exercise. The Tribunal will be well aware of that in  
18 view of all the evidence, material, the judgments the Tribunal has issued. Even with all that  
19 material, the Tribunal did not feel able to reach a final conclusion on this without referring  
20 the matter back.

21 THE CHAIRMAN: They said it was a short point, or something.

22 MR. ANDERSON: A short referral, yes. They gave us six months, and we used the six months.  
23 We used it comprehensively, and we looked at all aspects of the costs attributable to the  
24 service of transportation and partial treatment of water for Albion's supply to Shotton. We  
25 took the full six months. Our report runs to 225 pages. We have five lever arch files of  
26 supporting evidence.

27 The parties were fully involved in that exercise. Many of the points raised by them now, in  
28 their comments on the schedule and indeed in their written submissions and oral  
29 submissions before you, have been rehearsed, debated, considered, and the Authority's  
30 position on those matters is set out in the final report.

31 I do not propose to re-visit all those arguments this afternoon - indeed, time would not  
32 permit me to do so. I will, however, go quickly through the helpful schedule of points  
33 which Mr. Thompson produced yesterday - simply, in some cases, to point the Tribunal to  
34 where we have dealt with them shortly.

1 Of course, whether the Tribunal wishes to re-visit all those points is a matter for it. We hope  
2 we have explained fully why we took the views and reached the conclusions that we did.  
3 We have set those out extensively in writing - both in the final report and in our comments  
4 and submissions since that report. We believe that our explanations are self-explanatory.  
5 The next point I wish to make - and it has been made before by us - is that this is not a  
6 decision against which any party is appealing. Our decision has already been set aside. In a  
7 sense, therefore, the role of the Authority in these proceedings is complete in the sense that  
8 the Tribunal has now taken upon itself the task of deciding the issue of excessive pricing,  
9 and, in a sense, it sub-contracts to the Authority the task of going and gathering information  
10 to assist it. You have a dispute between the two parties - Welsh and Albion - as to whether  
11 that material demonstrates an abuse of price or not.

12 THE CHAIRMAN: Are you going to address Mr. Vajda's point about on what basis we look at  
13 this material?

14 MR. ANDERSON: I was going to do that at just this moment.

15 THE CHAIRMAN: Thank you very much.

16 MR. ANDERSON: Welsh submitted at the last CMC, and most recently in its reply skeleton and  
17 today, that the Tribunal should not be drawn into a full merits consideration of the final  
18 report with a view to unpicking and second-guessing the factual investigation undertaken by  
19 the Authority. In our view there is a lot of merit in that approach. We submit the Tribunal  
20 should concentrate on important points of principle. The point is this: the Authority has  
21 investigated the costs attributable on three methodologies. I will be explaining briefly why  
22 we have taken the methodologies we did. It has reached certain conclusions on the costs  
23 and reached a view on the extent to which the price exceeded those costs. It is an  
24 experienced regulator. It has exercised judgment. It has made assumptions on a number of  
25 matters.

26 It is perfectly possible that on some of the individual matters the Tribunal may take a  
27 different view, but when coming to consider whether the first access price was abusive, the  
28 Tribunal, in our submission, is bound to have regard to the fact that the regulator has  
29 reasonably reached the position it has reached in its final report. It therefore may, in effect,  
30 amount to the same thing as a judicial review test before the Tribunal could move on and  
31 conclude that what the Authority did was so wrong that it can be, if you like, in important  
32 respects, set aside and the Tribunal would substitute its own conclusions.

33 THE CHAIRMAN: You say the Tribunal would substitute its own conclusions, but if one set  
34 aside the information and wanted to go down a different route, then what would you do?

1 MR. ANDERSON: What the Tribunal elected to do by referring this work was to say, "We are  
2 going to take the decision ourselves. You, Authority, go off and investigate it and report  
3 back to us with the information. That we have now done. It is now for the Tribunal to  
4 decide how it is going to proceed to take the decision it decided last time it now wished to  
5 take. We have done what we can to assist you. I am here today to explain what we have  
6 done. If you do not like what we have done, well, then you have got a problem. That is the  
7 course that the Tribunal elected to go down. It may be, in those circumstances, that the  
8 Tribunal can only conclude that there was insufficient evidence that the price was excessive  
9 or abusively excessive.

10 I mentioned this morning - and I simply repeat very quickly - that in our submission the  
11 Tribunal should disregard the calculations, the tables and the figures in the document  
12 submitted by Albion a couple of days ago. It may be that much of that information is  
13 derived from the twenty-nine page analysis which we asked to see - which, indeed, the  
14 Tribunal asked Albion to provide to us, but they never did - possibly adjusted to take  
15 account of the revisions coming out of the composite schedule exercise.

16 The Tribunal should be aware of three important regulatory market changes which have  
17 happened since 2001, and how these changes will impact on the results our preferred AAC-  
18 plus methodology. The first is that the regulated cost of capital was increased in the 2004  
19 periodic review; secondly, the company's assets were re-valued at that periodic review (the  
20 value of some assets - resources, pumping, storage and so on - went up; the value of other  
21 assets -primarily the distribution mains - went down); thirdly, the non-potable customer  
22 class demand has declined sharply since 2000/2001. That is largely as a result of a  
23 substantial drop in demand from CORUS. The net result of those changes is that the AAC  
24 figure would now be higher than our calculation of what it would have been in 2000/2001.  
25 For the purposes of today's hearing I intend to concentrate on the following main points:  
26 firstly, why we have selected the three methodologies we selected; and, secondly, the main  
27 points of dispute in Mr. Thompson's schedule. I do not propose to go through the points of  
28 dispute made by Welsh in the schedule, largely because Mr. Vajda has not because we have  
29 addressed, we believe, those points in our third column in the schedule. The next point is  
30 other evidence advanced, particularly by Albion, and, finally, the correct approach on  
31 fairness. I will, of course, endeavour to answer any questions the Tribunal has by way of  
32 clarification, but it may be that to some of those questions - particularly if they are of a  
33 technical detailed nature - I may have to ask to be able to respond in writing.

1 Turning to the three methodologies -- The Tribunal asked us to investigate further “the costs  
2 reasonably attributable to the service of the transportation and partial treatment of water by  
3 Dŵr Cymru generally and through the Ashgrove system in particular”. As I say, the  
4 purpose in doing that was to assist the Tribunal in determining the question of whether or  
5 not the first access price was materially in excess of the relevant costs and go on to  
6 consider, if that were the case, whether the price was unfair.

7 We adopted three methodologies - what is called ‘the average accounting cost plus’ (AAC-  
8 plus), long run incremental cost and a local accounting cost approach. The latter, as we  
9 made clear in the final report, might better be described as a local hybrid cost because, of  
10 course, in this industry, for regulatory purposes, there are no local accounts of that kind  
11 because we asked for information on a regional average basis. There are problems of  
12 identification, allocation and extrapolation in producing a local cross-check.

13 THE CHAIRMAN: When you say ‘local’ - just so that I am absolutely clear - that means ----

14 MR. ANDERSON: -- specific to the Ashgrove system.

15 PROFESSOR PICKERING: The regulator is not telling the companies how to run their  
16 businesses, is he?

17 MR. ANDERSON: Well, I think that would be highly debatable. In some senses they are, in the  
18 sense that they operate under a price cap. They are allocated a regulatory cost of capital,  
19 they may do better or worse than that, but of course that would then affect in the  
20 rebalancing in the next five year periodic review. There are an awful lot of other  
21 obligations that arise out of the fact that it is a regulated industry.

22 PROFESSOR PICKERING: These are intended, of course, to proxy the sorts of disciplines and  
23 constraints that a competitive market would be likely to generate in relation to other  
24 industries?

25 MR. ANDERSON: That is the broad idea yes, Professor, yes.

26 PROFESSOR PICKERING: A company that is answerable to shareholders, of which we have a  
27 number of public companies in the water sector ----

28 MR. ANDERSON: Yes.

29 PROFESSOR PICKERING: -- and other stakeholders must presumably be assumed to exercise  
30 its own managerial judgment as to what it needs to run its business effectively and  
31 efficiently as well as whatever requirements the Regulator imposes upon the companies  
32 from the point of view of information flows.

33 MR. ANDERSON: Of course, and we explored on previous occasions what actual accounting  
34 information is available and Ashgrove specific accounting information is not available, has

1 not been generated and that is why there has been an element of extrapolation and  
2 assumption in what we call the “local accounting cost” exercise.

3 THE CHAIRMAN: So when you say “hybrid” you really mean “assumption” ?

4 MR. ANDERSON: Yes.

5 THE CHAIRMAN: Because “hybrid” usually means bringing two things together.

6 MR. ANDERSON: Well it is, it is a bit of both.

7 THE CHAIRMAN: But it is really assumption.

8 MR. ANDERSON: Partly assumption, that is why we say “hybrid”, it is partly assumption and  
9 partly simply taken from various accounts.

10 THE CHAIRMAN: Yes, I think I understand what you mean now.

11 MR. ANDERSON: What we have not sought to do in the financial report is revisit the original  
12 FAP calculations, save to the extent the origin of some of the figures for the AAC plus was  
13 used in the context of the first access price and our assessment of that access price in our  
14 original decision. Nor have we used or relied upon any of the methodologies – and I think  
15 we are up to something like nine or ten methodologies – submitted in the course of the  
16 proceedings. We have not revisited those. What we have done is, as we believed the  
17 Tribunal wished us to do, is started from scratch. We have gone and looked at the actual  
18 costs in the case of the LAC, a new exercise – the LRIC, and the average accounting cost  
19 plus is a much more granular or disaggregated average accounting cost exercise than had  
20 previously been undertaken.

21 Similarly, we have not advanced a stand-alone methodology, and we have done that  
22 because in our view the Tribunal made it abundantly clear to us last time ‘round that that  
23 was not an exercise that they were looking for or found helpful.

24 The AAC plus approach is the Authority’s preferred methodology and the other two are  
25 essentially cross checks on that approach. That is not surprising because average  
26 accounting remains essentially the basis upon which we regulate the industry. We adopted  
27 AAC plus for three main reasons. First, an average accounting cost methodology was the  
28 basis in fact used for setting the first access price. Secondly, in our MD163 of June 2000 –  
29 the relevant one at the time - average accounting costs were one of the three main ways of  
30 setting access prices. Thirdly, an AAC approach provides insight into the regulatory price  
31 level, and that is the approach which is generally used in the water industry to set prices.  
32 So the AAC approach informs the view on what the correct costs are for the relevant service  
33 generally, and I will address the question of the back-up supply, but generally it forms the

1 level of costs appropriate to this kind of supply generally rather than for the Ashgrove  
2 system specifically.

3 In the referred work under the AAC methodology, as we believe was expected of us we  
4 undertook a greater degree of granularity than had been undertaken in our initial  
5 investigation. The approach recognises that at least in one important respect the actual  
6 service required in this case involved a back-up supply, but other than that we costed it on  
7 an entirely regional average basis. We included the back-up supply, and I will deal with  
8 this in a little more detail in a moment but just to foreshadow what I will say, what we did  
9 was to identify the nature of the service actually required. In this particular case a back-up  
10 service was required and in our view (and this is why we included it) that service was  
11 reasonably attributable to the service of transportation – it was a back-up for transportation.  
12 Having disaggregated to the extent that we did it was no longer included in the regional  
13 average costs we were using in the way that it previously had been, because previously we  
14 were simply reading across from potable distribution to non-potable distribution which is  
15 why we say it was originally included within the methodology of the FAP, and we costed  
16 the back-up supply on a regional average basis. We did not seek to identify the specific  
17 costs of supply making this back up supply to Albion; we calculated it by reference to 15  
18 per cent of average potable costs effectively, is how we got there. So what we say the AAC  
19 plus purports to show is the relevant regional average cost of providing a service of the kind  
20 that Albion required for supply to Shotton, and that is how we have interpreted the phrase  
21 “costs generally”. In other words, it is the costs generally of providing a service of the kind  
22 required by Albion.

23 One has to bear in mind, of course, for purposes in any regional average accounting  
24 approach to non-potable customers that non-potable customers generally in Wales are a  
25 pretty unique group, each one of them is served by a discrete system, and that is explained  
26 in the final report at 6.13 and 6.14.

27 We also believe that the AAC plus approach assists in determining whether any excess of  
28 price over costs is unfair in the *United Brands*’ sense, and we say that because in the  
29 absence of relevant comparators, and in the absence of our view of relevant externalities,  
30 the regional average price of supplying, or making this service provides a good surrogate  
31 for the economic value. It is a benchmark against which the FAP can be assessed.

32 Albion has argued, at p.136 et seq in the composite schedule, that the AAC plus is a  
33 bespoke methodology which they can see: “... no honest or lawful explanation” for its use.  
34 We are not quite sure what they mean by that, but the argument was developed yesterday

1 that it was somehow inconsistent with our regulatory approach to tariff setting – that was  
2 one of Mr. Thompson’s four principles.

3 Well, yes it is, in a sense, inconsistent with our regulatory principles, because it  
4 disaggregates to a greater level than we require, but that was done because we believed that  
5 is what the Tribunal asked us to do. We are undertaking a task to assist the Tribunal in  
6 reaching a view on whether the first access price is abusive. We are not exercising a  
7 regulatory function in this respect; and that is an important point when we come on to some  
8 of the issues that Professor Pickering is raising about whether a particular approach is the  
9 approach most inductive to efficiency. That is a regulatory function. In this task we are  
10 looking to see whether Welsh quoted an abusive price, they are different exercises.

11 PROFESSOR PICKERING: Sorry, just to say but of course the European Court takes the view  
12 that there is no justification for finding as non-abusive a price that is based upon excessive  
13 costs.

14 MR. ANDERSON: Of course, if you are so inefficient that charging by reference to your costs  
15 puts your costs out of line with your competitive or surrogate for a competitive price, then  
16 that could well be abusive; I would accept that. But there is no suggestion here, and we  
17 would have been singularly failing in our tasks as regulator with a price cap over the last 15  
18 years to suggest that the costs of Welsh fall into that kind of category.

19 So that is what we mean when we say we would not necessarily adopt this approach in a  
20 regulatory context, and Mr. Thompson may find that an extraordinary thing to say; we think  
21 it is the natural consequence of what we were asked to do.

22 LRIC was used as a cross-check, and we chose it for two reasons. First, it is very similar to  
23 the long run marginal cost which was the basis we used to consider the correct level for the  
24 second bulk supply agreement price. It is also one of the methodologies described in  
25 MD163 for considering access prices at the time; and thirdly, it is a well recognised  
26 methodology employed in other industries, and that is the point we make in the final report  
27 at para.6.20.

28 Two main points arise out of that methodology. First, it is by definition a long run  
29 incremental cost and not a short run incremental cost, and that is a point that Mr. Vajda has  
30 made. It is therefore necessary to include within it by definition an assumption that will give  
31 rise to some capital investment. Otherwise, in our judgment it is not a long run incremental  
32 cost, it is a short run incremental cost. We selected 20 per cent because at any level  
33 materially below 20 per cent there would be no capital investment needed. I think Mr.

1 Thompson does not shy away from the fact that his preferred increment of 10 per cent  
2 would fall short of requiring any investment.

3 So we have picked the 20 per cent increment in order to generate capital investment. It is  
4 not intended to indicate our view of what we think demand will, in fact, be. It is simply  
5 designed to generate capital investment which is a necessary pre-condition to producing a  
6 long-run incremental cost methodology appropriate for an industry of this kind. Otherwise,  
7 a price based on short run incremental cost would not include any contribution towards  
8 capital cost in the industry and thereby understate the position to a very material extent.

9 The second point we make is that it is what we call a “pure” long run incremental cost in the  
10 sense that we only included costs that were sensitive to an increase in demand.

11 Now, we excluded back-up supply on the grounds that it was not sensitive to incremental  
12 changes in demand. Of course, strictly speaking the back-up supply would be or could be  
13 sensitive to significant – very significant – increases in demand. So we were perhaps being  
14 simplistic when we said it would never be sensitive to demand, but there would need to be  
15 big changes in demand for there to be a material change in the back-up supply costs. That  
16 is why we excluded it from our calculation of the long run incremental costs, although, a  
17 point that Mr. Vajda has made on a couple of occasions, we recognise that if one was to set  
18 one’s price on that basis one would be under recovering and therefore one needs to take into  
19 account those costs we have excluded in order to set an appropriate price.

20 PROFESSOR PICKERING: I am sorry to interrupt, Mr. Anderson, but hopefully it gives you a  
21 moment to get a sip of water anyway! Dr. Marshall’s comment was about long run  
22 marginal cost is implicit on the basis that long run marginal costs will be lower than long  
23 run average costs. Therefore, she was pointing to the need for a two part tariff, maybe with  
24 Ramsey pricing, or something like that. What is your understanding of the relationship  
25 between long run marginal cost and long run incremental cost? Do you treat them  
26 alternatives or do you consider them to be different?

27 MR. ANDERSON: I have certainly treated them as being so similar as not to be a material  
28 difference, but those behind me may have a different view and they will no doubt correct  
29 me if what I have said is not right. They certainly took the view that Dr. Marshall’s  
30 comments were applicable to the methodology that they had employed. The theory of what  
31 she says, from my understanding of the long run increment cost methodology that we used,  
32 would certainly be applicable to it. What other differences there may be, I will need to rely  
33 on those behind me to tell me.

1 The local accounting cost we describe in paras.6.30 to 6.41 of the final report, and we  
2 adopted that methodology in view of the Tribunal’s enthusiasm for a local cross-check on  
3 any average accounting method used. This is not a method, as I say, traditionally employed  
4 by the Authority and, as I said earlier, the relevant costs figures are not ones the Authority  
5 requires water undertakers to produce. Again, this is advanced as a cross-check. A point  
6 we make in the final report is that in many respects it is a better cross-check on individual  
7 components in the average accounting costs methodology than in an overall sense.

8 Let me now turn, if I may, to specific criticisms that have been levelled against aspects of  
9 our work. It may be of assistance now if the Tribunal were to have to hand  
10 Mr. Thompson’s two page document which contained a summary of the four governing  
11 principles and then a helpful list of the pages in the Authority’s report, the number in  
12 Albion’s schedule and then the subject matter of the point.

13 Before turning to the detail of the schedule could I just say a few words on the issues of  
14 principle document, which I think Mr. Thompson described as the “governing principles for  
15 all issues arising in this case”. We do not accept that those are the governing principles.  
16 What we have done in our final report is to seek to provide information in which it was  
17 clear from the three main judgments the Tribunal were seeking that it is a different task to  
18 the task of undertaking regulatory tariff approval or setting.

19 The first principle, costs must be reasonably attributable either to transportation or partial  
20 treatment: in our submission, that is too narrow a view of what the Tribunal was asking.  
21 What the Tribunal was asking for were the costs attributable to the service of transportation  
22 and partial treatment. This is the critical point on back-up supply. It is a service that is  
23 attributable to, it is an activity that is attributable to a service of transportation. It is needed  
24 in this case. It is not needed in the case of CORUS, because they have got their own  
25 lagoons. Shotton does not, Albion does not. So the back-up supply is designed to augment  
26 the service of transportation when that service, for example, breaks down.

27 The Tribunal, para.249 of its further judgment, only required us to exclude inappropriate  
28 costs, and the example they cited were the retail costs, because clearly that is the activity of  
29 Albion itself.

30 The second principle is that the approach to be adopted to the identification and  
31 quantification of such costs must be consistent with the regulatory practice of the authority.  
32 We say that so far as the AAC is an average accounting costs approach, of course it is  
33 consistent with our approach. Indeed, that is one of the reasons why we picked it. It is to  
34 be borne in mind that a central dispute in this case from the beginning was a challenge by

1 Albion as to the appropriateness of using average accounting costs, at least without a local  
2 costs cross-check.

3 What we have done is carry out a bespoke exercise in accordance with the directions of the  
4 Tribunal. To the extent that that is a principle, it is a principle. To the extent that we have  
5 departed from it, we have departed from it, we would say, at the request of the Tribunal.  
6 The Tribunal made it quite clear – see, for example, paras.605 and 606 of the main  
7 judgment – that it wanted a greater level of disaggregation.

8 The third principle is the primary approach to the assessment of costs is the general or  
9 regional average approach. That is a departure. I suspect it is a departure because of the  
10 way the figures have turned out. Of course, in a sense, the general, the average accounting  
11 costs methodology, is our preferred methodology. In our submission, that does not mean  
12 that it would be appropriate to disregard the other two methodologies. That is why we took  
13 three methodologies, because to simply rely on one, in our view, would have been unsafe  
14 and we thought it would be of more assistance to the Tribunal to have these cross-checks,  
15 precisely what the Tribunal itself had been saying in the course of its judgments, a local  
16 cross-check is necessary to assess the appropriateness of the average accounting cost  
17 method. It did not like the stand-alone calculations that were done, so we have done the  
18 LRIC and the LAC to meet the Tribunal's request.

19 The fourth principle, on a more granular approach to the allocation of costs on a regional  
20 average basis adopted by the Authority on its principal AAC plus approach, costs are  
21 allocated to individual non-potable systems on the basis of the specific services that they  
22 receive. We do not accept that characterisation of what we have done. Aside from the  
23 special case of the back-up supply, for the reasons I have explained, we have allocated all  
24 functions that are inherent in non-potable transportation and non-potable treatment, whether  
25 or not any particular system requires all those functions or not. To do otherwise would have  
26 been consistent with a regional average accounting approach. The whole point of it is that  
27 the overall costs of all functions inherent in transportation are included, whether or not any  
28 particular system, as I say, benefits from all of them. The back-up supply is a different  
29 issue because that is not an inherent part of transportation, it is a service necessary in this  
30 case to augment the transportation.

31 THE CHAIRMAN: Why is it necessary in this case and not in all the other cases?

32 MR. ANDERSON: It may be necessary in some other cases, but in other cases they do not need a  
33 back-up supply supplied by the person from whom they are securing the common carriage.

34 THE CHAIRMAN: CORUS?

1 MR. ANDERSON: In the case of CORUS, because CORUS have their own lagoons. Others  
2 may have an alternative source. In this particular case when Albion was asked what back-  
3 up arrangements it wanted under common carriage its answer was, "As at present".  
4 THE CHAIRMAN: I understand that, but did you then look to see that the other non-potable  
5 supplies had their own lagoons, therefore did not require it.  
6 MR. ANDERSON: Yes.  
7 THE CHAIRMAN: So this is the only one that may require it?  
8 MR. ANDERSON: It is the only one, yes.  
9 THE CHAIRMAN: So if you are looking at regional average cost and the idea that even if you  
10 are not going to have that, even if one person does not require that service, it was provided.  
11 The difference here is that it is a discrete service?  
12 MR. ANDERSON: The difference here is that it is a discrete service, it is not an inherent part of  
13 the transportation or the treatment.  
14 THE CHAIRMAN: No, but it is discrete in the sense that it is discrete to the Ashgrove system.  
15 MR. ANDERSON: It is unique.  
16 THE CHAIRMAN: It is unique. In the port it is has to be in the port.  
17 MR. ANDERSON: Yes.  
18 THE CHAIRMAN: But if you were supplying everybody but Shotton you would not need it at  
19 all?  
20 MR. ANDERSON: That is correct.  
21 PROFESSOR PICKERING: So why, Mr. Anderson, do we have the inclusion of the distribution  
22 pumping, although it is discretely not required by Albion?  
23 MR. ANDERSON: Distribution pumping is an inherent function of transportation, back-up  
24 supply is not. Back-up supply is an augment service.  
25 THE CHAIRMAN: My understanding, and can we see whether my understanding is right, is that  
26 you have got five other non-potable customers and none of them need back-up supply. You  
27 put in specific back-up supply for customer six. So you could draw a line and that is  
28 discrete, that supply is discrete. Are you saying that the pumping is something which is  
29 somewhere within everybody?  
30 MR. ANDERSON: Yes. It is caught within the non-potable distribution costs. Because we  
31 disaggregated, this back-up supply cost has now fallen out and has no home. Previously,  
32 when the first access price was calculated the back-up supply was implicitly included as a  
33 cost for everyone because what was done in those primitive days was simply to equate non-  
34 potable distribution with potable distribution.

1 THE CHAIRMAN: You still have not answered my question because of the words I used. You  
2 have talked about cost. I am just looking at the facilities. The pumping facility is a  
3 pumping facility which is there and is necessary in order for the transportation to occur to  
4 all six?

5 MR. ANDERSON: No.

6 THE CHAIRMAN: Well, it is available to all six.

7 MR. ANDERSON: All non-potable systems are discrete. Some systems will require pumping,  
8 some will not. The distinction I am drawing between back-up supply and pumping is that  
9 pumping is an inherent function of transportation, back-up is not. Back-up is a fall-back,  
10 but it is a service that is attributable to the transportation of water.

11 PROFESSOR PICKERING: Mr. Anderson, is it not the case that what is inherent in the  
12 distribution system is the pipeline and not the pumping?

13 MR. ANDERSON: We would say not because your pipe is no use to you if water will not move  
14 along it. In this particular case water travels down it because of gravity. It is a type through  
15 which water can move.

16 THE CHAIRMAN: So the pump is not inherent?

17 MR. ANDERSON: Yes, it is inherent to the transportation of water. It may not be inherent to the  
18 pipe, but it is certainly inherent to the transportation of water.

19 PROFESSOR PICKERING: In some systems.

20 MR. ANDERSON: In systems where the pipe goes up a hill, yes.

21 PROFESSOR PICKERING: That is right.

22 THE CHAIRMAN: But is it the same pipe that goes down the hill and up the hill?

23 MR. ANDERSON: Well, some pipes may go partly uphill and partly downhill

24 THE CHAIRMAN: So that it would not be needed for the down, but it would be needed for the  
25 up.

26 MR. ANDERSON: You may only need pumping for part of your pipeline, that is true.

27 THE CHAIRMAN: Which is where I was trying to get to.

28 MR. ANDERSON: In this particular case, the only pumping was pumping from the River Dee or  
29 from Heronbridge - the abstraction point - to Ashgrove. Ashgrove to Shotton was 15km but  
30 it was steadily downhill and so it did not require any pumping, which is why Albion are  
31 saying it is unfair for your average accounting costs to include an element of pumping.

32 THE CHAIRMAN: But the pump is one pump which is used for all the six systems?

33 MR. ANDERSON: No. No . Each system ----

34 THE CHAIRMAN: -- has its own pump.

1 MR. ANDERSON: -- that needs pumping will have its own pump because they are not  
2 connected. The Ashgrove system is entirely discrete. The water comes out of the River  
3 Dee. It comes out at Heronbridge. It is taken to Ashgrove, where it is treated. Then it is  
4 delivered to two and only two customers - CORUS and Shotton.

5 THE CHAIRMAN: So why is that like the idea of the port with costs within the port -- The  
6 facilities are there, but you do not use them. Here it is all separate.

7 MR. ANDERSON: Albion uses all the facilities that are there - it uses the pipe; it uses the  
8 treatment works; it effectively uses the abstraction pump ----

9 THE CHAIRMAN: But it does not use this pumping? It does use this pumping?

10 MR. ANDERSON: Let me explain. There are two pumps -- There are two concepts of pumping.  
11 There is water resource pumping and there is distribution pumping. In this particular case  
12 water resource pumping is required and Albion will be purchasing that from United  
13 Utilities. We have expressly excluded that on our calculations -- the local accounting cost  
14 calculations because that would not be part of the common carriage arrangement. There is  
15 no distribution pumping anywhere on the Ashgrove system. But, there is distribution  
16 pumping on other non-potable distribution systems within Welsh Water's area, and it is  
17 therefore the overall costs of distribution pumping which are included in a regional average  
18 calculation of the costs of transportation.

19 That debate has in fact dealt with a lot of the points I wanted to make on Item A in Mr.  
20 Thompson's schedule - the back-up supply principle. If I could just go through the points  
21 quickly - just so that they are on the transcript -- Distribution pumping is different in the  
22 sense that it is an integral function of the transportation service. You cannot transport on  
23 some systems without it. Where it is needed it is necessary for transportation. Back-up  
24 supply is different. It is not part of the transportation service as such, but is attributable to  
25 the transportation service because in this case it is necessary to augment it. It is, in our  
26 submission, a service attributable to the service of transportation and distribution. It was  
27 implicitly included within the first access price because of the high level distribution costs  
28 (back in those days) of 16 pence. You will see now from the figures in the final report (p.46,  
29 para. 5.62 where that is explained - I will take you to it in a moment) -- At Table 16 (final  
30 report, p.127) you will see that the non-potable distribution which previously included  
31 everything in a global 16 pence has been broken down and is now only 2.6 pence. It may  
32 have gone up slightly in the response -- It has gone up to 2 pence in the response because  
33 we have added back in the distribution pumping.

1 The way in which we have calculated the cost of the back-up supply is, in a sense, a  
2 regional average one because it is done by references to Welsh's non-potable -- potable  
3 distribution costs generally. We have not attempted - because it is an AAC-plus approach -  
4 to cost the specific service of supplying a back-up supply to Albion at Ashgrove.  
5 Those points are made in the final report at para. 5.62, if I could ask the Tribunal just to turn  
6 that up briefly.

7 "Given the uncertainty, it would be reasonable to assume that the costs of the back-up  
8 supply were implicitly included in the first access price for the following reasons: (1)  
9 the back-up supply was 'bundled' into the existing second bulk supply agreement in  
10 2000/2001 and Albion responded on 20<sup>th</sup> October 2000 to Welsh's network access  
11 questionnaire that it wanted contingency supply arrangements under common carriage  
12 to continue 'as at present';

13 (2) There is no convincing evidence to support: (1) Albion's claim that it was clear to  
14 all parties that the back-up supply would have been included as part of a separate  
15 potable bulk supply agreement with Dŵr Cymru ; or (2) the possibility that Dŵr  
16 Cymru mentions (but dismisses) of the back-up supply continue as part of a potable-  
17 water-only-second bulk supply agreement without the costs of the back-up supply  
18 being paid for by the revenue accruing from the first access price;

19 (3) Dŵr Cymru's original calculation of the first access price was based on an  
20 allocation of average revenues used as a proxy for Dŵr Cymru 's average costs which  
21 include all costs including those of the back-up potable supply to Shotton Paper. In  
22 this way the distribution cost of the back-up potable supply was implicitly included in  
23 Dwr Cymru's calculation of the first access price (because Dŵr Cymru read-across  
24 the costs of potable bulk distribution to non-potable bulk distribution). There was no  
25 explicit allowance for the back-up supply in Dŵr Cymru 's calculation of the first  
26 access price because there was no explicit costing of any particular element of the  
27 Ashgrove supply as it was based on an ACC methodology".

28 The next item, Item B on the schedule is how we calculate it - the back-up supply. This is  
29 set out in para. 6.95 to 6.105 of the final report. We assumed, for illustrative purposes, that  
30 15 percent of potable treatment capital costs and 15 percent of resource capital costs were  
31 attributable to the back-up supply. This was explained at pp.10 to 12 of the schedule. The  
32 three main points to make are: (1) that the cost is not zero as alleged by Albion. Albion's  
33 case is that, "There is headroom in the system. Therefore we should get this for nothing".  
34 Equally, the weighting of 90 percent suggested by Dŵr Cymru was not accepted because

1 Albion did not benefit from a dedicated water resource back-up service. Welsh was in fact  
2 using the headroom. So, we used 15 percent as the traditional target headroom in the water  
3 industry, set at around 15 percent.

4 Using 15 percent would mean a twenty-four hour, 8 million litre a day supply, and that  
5 would have cost Welsh 10 pence per cubic metre to provide in 2000/2001. That is  
6 equivalent to 4.4 if re-based on the average volume of water supplied to Shotton. This is  
7 explained in that section. The cost does not make any allowance for the operational control  
8 needed to manage the back-up supply. It is used - I forget how frequently, but it has been  
9 used.

10 Albion has worked out that at 4.4 pence per litre that equates to around £300,000 per year.  
11 Yes, that is a lot of money, but what the Tribunal needs to bear in mind is that supplying  
12 water to Shotton is equivalent to supplying water to a small town. That is how much water  
13 they use.

14 THE CHAIRMAN: Can I just get something clear in my mind? You were very helpful before.

15 The 4.4 pence -- That price is for what facility? I understand it is for back-up supply. What  
16 does that mean?

17 MR. ANDERSON: It means that when the non-potable water system breaks down a large  
18 organisation like Shotton needs water and cannot make ----

19 THE CHAIRMAN: No. I understand all that. Is it the costs of somebody that puts a different hat  
20 on? Is it the cost of having to keep water in a different place?

21 MR. ANDERSON: It is costs attributable to diverting potable water from a potable water system  
22 to Shotton when the non-potable water has broken down.

23 THE CHAIRMAN: So, it is the resource or the facility for the diversion of water from ----

24 MR. ANDERSON: It is more than that of course. It requires a contribution to the costs of that  
25 potable system as a whole. It is not just the costs of diverting it. Indeed, the operational  
26 management was a cost that was excluded from the calculation of the attributable costs.

27 THE CHAIRMAN: So, it is the percentage cost of having the supply available.

28 MR. ANDERSON: Yes, effectively. It is a percentage of the potable distribution cost.

29 THE CHAIRMAN: That is what you meant by the headroom sort of idea.

30 MR. ANDERSON: Yes.

31 PROFESSOR PICKERING: In case it is any help, Mr. Anderson, it is about paras. 6.101 to 6.105  
32 in the final report.

33 MR. ANDERSON: 6.102 in particular.

34 PROFESSOR PICKERING: Yes.

1 MR. ANDERSON: (After a pause): That is how we calculate it.

2 PROFESSOR PICKERING: Paragraph 6.104 is quite important because it is highly sensitive to  
3 the assumption that is made as to the proportion of the resource capital costs that are  
4 attributable to the back-up. You say 15 percent. Dwr Cymru suggested 95 percent -- or,  
5 possibly as high as 95 percent.

6 MR. ANDERSON: I agree. At paras. 10 to 12 of the schedule we have explained why we went  
7 for 15 percent.

8 THE CHAIRMAN: Yes. But, why I get confused about this is that Dŵr Cymru says it is 95  
9 percent. If it is the way you have just described it, it cannot be 95 percent of the cost of all  
10 potable water because this is only a little bit of all potable water and the risk is not every  
11 day.

12 MR. ANDERSON: We rejected the 95 percent.

13 THE CHAIRMAN: I know, yes.

14 MR. ANDERSON: We selected 15 percent on the grounds that the headroom was currently 10  
15 percent, was about 25 percent ----

16 THE CHAIRMAN: What you are really saying is that you could have a facility which was 15  
17 percent less than the facility you need which allows ---- No, he is saying I am wrong.

18 MR. ANDERSON: I am not sure who it was who was saying you were wrong. Somebody  
19 behind me or somebody else?

20 THE CHAIRMAN: The man with the check tie.

21 MR. ANDERSON: Well, he should know! (Laughter)

22 PROFESSOR PICKERING: Basically it is the same potable water that is supplied to Shotton  
23 Paper which is not a matter for consideration in this case. But, this is further water that is  
24 available from Bretton which would be sent along a separate supply line where the non-  
25 potable water resources failed for whatever reason.

26 MR. ANDERSON: Yes. But, of course, being potable water it is treated somewhere else - not at  
27 Ashgrove.

28 PROFESSOR PICKERING: Yes.

29 MR. ANDERSON: The next item is sludge disposal under the AAC-plus. This is dealt with at  
30 pages 13 to 17 of the schedule, we say it is a necessary consequence of water treatment and  
31 here we are on the other aspect – not the transportation, the treatment. In this case sludge is  
32 created and you need to get rid of it. It is true, and we recognise this at p.15 of the schedule,  
33 that strictly speaking the logic of including this would require some tariff rebalancing,  
34 because at the moment it is accounted for in the sewage side of things and not the water cost

1 side of things, but rebalancing would amount to a tiny amount of money when spread across  
2 everybody. This is part of the consequence of going back to this and doing it at a more  
3 disaggregated level and looking at it afresh, that is why we say properly interpreted and  
4 construed, this is attributable to the treatment of water; that is what is creating it and it needs  
5 to be disposed of. That is one of the reasons why the treatment costs are in fact higher than  
6 the bracket of treatment figures that the Tribunal at that stage of the inquiry had identified  
7 in its Judgment.

8 THE CHAIRMAN: But you normally treat that as sewage.

9 MR. ANDERSON: It was at the time accounted for in that sense but looking now at the cost it is  
10 a cost in fact attributable to treatment, and that is the question we have been asked.  
11 Water distribution pumping, again we have discussed that, that is item D. If I could just ask  
12 you to look at p.17 of the schedule very briefly because the main point that Albion was  
13 making on this was that they purchased this from United Utilities. The point that we make  
14 at p.17 is that one needs to draw a distinction between the distribution pumping and the  
15 water resource pumping. You will see at the bottom of p.17 on the right hand column of the  
16 Authority's response:

17 "Under the proposed access arrangement, Albion is effectively seeking to by-pass  
18 Dŵr Cymru's water resource pumping assets, (i.e. its 52 non-potable source/intake  
19 pumping stations by purchasing this particular pumping sub-function directly from  
20 United Utilities."

21 Then, over the page:

22 "So on a regional average cost basis, the Authority accepts that there is a strong  
23 case for including the costs associated with non-potable water distribution  
24 pumping. However, there is still no case for including any of the costs of water  
25 resource pumping, which forms the majority of the pumping on these non-potable  
26 systems."

27 So we have addressed the point about purchasing it from ...

28 The next point, item E, was what is called the "MEAV Crosscheck". The point of  
29 complaint here is that certain MEA figures provided to us by Welsh we did not use, but we  
30 used much larger figures and for the charges we should have used the lower Welsh MEAV  
31 figures supplied. This is a point which has been addressed at length at annex 1 to our  
32 response which is to be found at tab 6 in bundle 40. The essential problem was, as we  
33 explained in the final report around p.121, was that the Welsh figures were incomplete, and

1 if you just open the final report at para.7.128, that is the heart of the point, The Authority's  
2 view on this is explained, as I say, more fully in the annex to the response:

3 "The Authority also notes that the main MEAV estimates (for both raw water  
4 aqueducts and non-potable distribution) provided by Dŵr Cymru are based on  
5 standard unit costs and not the unit costs used by Dŵr Cymru to estimate company  
6 wide MEAVs. As Dŵr Cymru has previously stated: *'it is important to remember  
7 that there are important differences between the context for preparing quotations  
8 for [The Authority's] standardised cost base projects ... and the context of  
9 estimating modern equivalent asset values.'*"

10 See the letter to Dr. Bryan attached to Christopher Alun Jones's first witness statement. Of  
11 course, the figure we used we have not just dreamt up, they are in fact derived from Welsh  
12 again. They are the figures to be found in CAJ-I, and that point is made clear at para. 7.86  
13 of the final report where these figures have been obtained.

14 The annex, bundle 40, tab 6 – if one looks, for example, at p.3 of that one sees that this is  
15 where this point is explained. So again we say we have more than adequately dealt with  
16 this point.

17 Stranded assets: we say the reason that this is included and it is accepted as a point of  
18 principle by Albion is because they are costs incurred so when one is approaching on an  
19 AAC basis there is no reason to exclude them. We do not believe that it is appropriate to  
20 exclude them because of what MD163 says, which does not actually say you cannot ever  
21 include them, it says you should try to make alternative use of them. But, of course, what  
22 we are doing here is a bespoke exercise. Albion's principal complaint in relation to stranded  
23 assets is the valuation but it is not a discrete point on valuation it is simply their return on  
24 capital point, and their MEAV, which should have used the lower incomplete Welsh MEAV  
25 figures, so it is not a discrete point on valuation of stranded asset.

26 PROFESSOR PICKERING: But it is a bygone is it not? A stranded asset has gone, the money  
27 has been spent – not even necessarily by Dŵr Cymru, but at some stage in the past, so what  
28 is the rationale for including it, presumably on an MEAV basis, which explicitly assumes  
29 that there is going to be new investment. But if an asset is already stranded then why at  
30 some stage in the future are we going to want to replace it?

31 MR. ANDERSON: My understanding is that this was a forward looking appreciation of assets  
32 that may become stranded. You are right, it is historic.

33 MR. THOMPSON: I think the main stranded asset is the notorious LG Phillips' main which was  
34 largely paid for by the Welsh Development Agency, I think that is the main stranded asset.

1 THE CHAIRMAN: Can we just make it clear, a stranded asset is something which is no longer  
2 being used – yes?

3 MR. ANDERSON: Yes.

4 THE CHAIRMAN: So this is something which, at some point, might have been used in the  
5 Ashgrove system is no longer being used, therefore will never be replaced, and is sitting  
6 there obsolete?

7 MR. ANDERSON: That is true, yes. But again, what one is talking about are regional average  
8 accounting costs. The fact that it is not located at Ashgrove is neither here nor there.

9 PROFESSOR PICKERING: But the fact that it is not located at Ashgrove raises the wider  
10 question of the implication of including the cost of a stranded asset for any non-potable  
11 customer. Why include something that has no economic value, or use, in the costing and  
12 the pricing that flows from it? I do not see that there is an economic rationale for it.

13 MR. ANDERSON: Well the costs have been incurred, and I do reiterate that Albion accepts in  
14 principle this cost should be included; their complaint was that the cost was too much not  
15 that it was not in principle correct to include it.

16 THE CHAIRMAN: And that you had not incurred the original cost?

17 MR. ANDERSON: He accepted that it was correct, as a matter of principle, to include this item  
18 in our cost allocations.

19 THE CHAIRMAN: What was just said about the LG mains?

20 MR. THOMPSON: I believe as a matter of fact that it has been valued on disaggregated cost of  
21 capital on an MEAV basis as if Dŵr Cymru had paid for it, but we say it should be, at best,  
22 the ordinary cost of capital at whatever value is appropriate for a stranded asset, taking into  
23 account the fact that somebody else had paid for it.

24 THE CHAIRMAN: I think I understand why you are saying that; can I just give this example and  
25 see? I am a painter, and I am going to paint a picture and I go out and buy the paints, and I  
26 buy 20 colours of paint. When I come to paint the picture I only use 19 of those colours.  
27 When I charge that painting, do I charge for the 20 colours or only the 19 colours?

28 MR. ANDERSON: It is our regulatory practice to remunerate water companies in respect of  
29 stranded assets?

30 THE CHAIRMAN: Which is the 20 colours?

31 MR. ANDERSON: The 20 colours, yes.

32 PROFESSOR PICKERING: Well, it is not your standard practice, is it, because of what you say  
33 in MD163, or are you telling us that MD163 is actually ignored?

1 MR. ANDERSON: No, my understanding is that what MD163 does – and I would need to go  
2 back and look to get the exact wording is – it exhorts companies to avoid stranding assets if  
3 they possibly can by, for example, finding alternative uses. There was a stranded asset in  
4 the Ashgrove system in the sense of the Sealand potable water treatment works which  
5 ceased being used for producing potable water and was then sold to Shotton who I think  
6 uses it for storing water.

7 PROFESSOR PICKERING: Well the best form of exhortation surely is to provide an incentive,  
8 and the incentive in this case, I would have thought, is the expectation that if a company  
9 does not find an alternative use for a stranded asset then it does not get any money in  
10 relation to it. Without that, if you are saying: “We would like you to find another use for it,  
11 but if you don’t we’ll still make sure that everybody else pays towards the costs of that”  
12 where is the incentive and the control in that?

13 MR. ANDERSON: Professor Pickering, we are moving slightly away from the exercise that we  
14 were undertaking here which was to identify the relevant costs for the purposes of  
15 ascertaining whether this price was abusive. It is our regulatory practice I am told that costs  
16 in respect of stranded assets are remunerated and it would therefore have been inappropriate  
17 when assessing Welsh’s access price to have excluded whatever the merits or otherwise of  
18 our role as a regulator in terms of how we treat standard assets, because we are not here  
19 engaged in the exercise of comparing the first access price with the most efficient price.  
20 We are here comparing the first access price with Welsh’s costs, and that is the exercise that  
21 we are engaged by.

22 PROFESSOR PICKERING: On the basis – and I am not challenging this, but I think the rider  
23 has to be added – that Dŵr Cymru’s costs are those of an efficient operator.

24 MR. ANDERSON: As efficient as everybody else in the industry, efficiency measured by  
25 reference to the measure that is applied to everyone in the industry, yes.

26 THE CHAIRMAN: On reasonable costs?

27 MR. ANDERSON: Yes, but that is our role as a regulator, not our role as a Competition Act  
28 enforcer.

29 Common Carriage Act services: the point in item (g), the AAC plus methodology, is  
30 simply returning to the old complaint about using average accounting costs, namely it has  
31 the effect of requiring Welsh or Albion to contribute towards the costs that it in fact  
32 incurred. It may be that that particular complaint has now been overtaken by Albion’s  
33 desire to encourage a use of average accounting costs at the expense of local costs.

1 Common carriage services, item (h): we say there is no duplication. This is explained at  
2 the bottom of p.25 and the top of p.26 of the schedule. These are the costs referable to  
3 setting up the common carriage.

4 Bad debts, item (i): we say again there is no double recovery here. We explain at pp.98 and  
5 99 of the final report, paras.7.20 to 7.26, and also at the bottom of p.35 of the schedule, that  
6 that bad debt costs should be borne by all as a forward looking risk based business cost.

7 Sludge disposal, item (j): we have now moved local accounting costs, and on any view  
8 sludge disposal as an exercise that does in fact have to be carried out at Ashgrove ought to a  
9 cost that is included in the local accounting costs.

10 We say the same in relation to the back-up supply in relation to a local accounting costs,  
11 because it is in fact supplied. Therefore, it is in fact a local cost, whatever the debates on  
12 the average accounting costs of the LRIC. We say it is clear in relation to a local cost.

13 So far as the doubtful debts is made at item (l), it is the same point that we make in respect  
14 of average accounts, namely every customer should make a contribution towards that  
15 particular cost. Obviously those that do not pay cannot be made to pay them so they have to  
16 be borne by the rest of the customers.

17 Scientific services and insurance have now gone.

18 Item (o), lack of workings: in our submission, we produced a great deal of information and  
19 explanation of how we had arrived at the figures we have arrived at. There were one or two  
20 places in which we accepted we could have provided more information. That was done on  
21 LRIC and MEAVs. That appears in the response.

22 Cost of capital: why have we disaggregated the costs of capital at all? Again, this is  
23 explained at paras.6.42 to 6.68 of the final report at pp.41-43 of the schedule. In brief, we  
24 say the answer is because the Tribunal asked us to disaggregate and it would be illogical to  
25 disaggregate all the costs except the costs of capital. That is the short point. We believe it  
26 is internally consistent to look at a disaggregated cost of capital when looking at more  
27 disaggregated costs.

28 PROFESSOR PICKERING: Is the cost of capital an overhead in the way that, for example, the  
29 cost of regulation would be, and is it therefore appropriate to apply a specific disaggregated  
30 cost to the one but maybe not to the other?

31 MR. ANDERSON: There is, of course, effectively a regulated cost of capital for an overall water  
32 business, but what we have done is been asked to look more specifically at parts of the  
33 business, and the view that has been taken in the light of evidence that was not available  
34 before the Tribunal but we secured in the course of this investigation, the June returns fed

1 through Europe economics, was to identify that if we are looking at this particular business,  
2 non-potable supply, there were more risks associated with that than with the general potable  
3 business because of larger amounts of water and larger fluctuations – it is not a question of  
4 trend, it is fluctuations – in demand. So if one is looking at the costs associated with that  
5 discrete business then, in our submission, it is appropriate to use rates of return that are  
6 appropriate to that disclose business. It is illogical, in our submission, not to do that. That  
7 is why we have done what we have done.

8 PROFESSOR PICKERING: Two points quickly: you are using rate of return and cost of capital  
9 there interchangeably.

10 MR. ANDERSON: I meant cost of capital.

11 PROFESSOR PICKERING: Fine. What is the difference between that argument on the cost of  
12 capital and the approach that you have adopted to spread on an average basis the cost of  
13 regulation, just as an example?

14 MR. ANDERSON: I would need to get instructions on that point, if those behind me have  
15 scribbled it down. One point, while they are doing that, that I should make clear is this:  
16 when we adopted the cost of capital we did in the average accounting cost mechanism, what  
17 we in fact did was use the actual rate of return that had been generated by Welsh at the time,  
18 which happened to be below its regulated cost of capital. It did not have very good rates of  
19 return at that time. The effect, therefore, of using 8 per cent is, in fact, to come out with a  
20 figure that is below the 1 per cent return on MEAV which this Tribunal used for illustrative  
21 purposes in the main judgment.

22 PROFESSOR PICKERING: You may be going to answer this when you reply to the points that I  
23 put, but if one treats the cost of capital as a cost and if that cost of capital is understood to be  
24 normal profit and that normal profit is the level of return that is required to keep the  
25 business in the industry concerned, then what is the rationale for there being any rate of  
26 return of capital, given that the cost of capital is the normal profit and that is presumably  
27 what the regulatory process is anxious to achieve. Therefore, if you include that as a cost,  
28 should not the further surplus over and above that be zero, or within plus or minus a  
29 reasonable range of zero?

30 MR. ANDERSON: I had not taken down before the short adjournment the question in quite as  
31 much detail as that, so I would need to think about that.

32 PROFESSOR PICKERING: I am elaborating on the point.

33 MR. ANDERSON: Absolutely and very helpfully. I am afraid that would have to be a point I  
34 would wish to take instructions on and respond to in writing, if that is permissible.

1 We have explained why we arrived at the figure of 11.1 for LAC and LRIC. It is derived  
2 from adding an adjustment for the increased risks for industrial non-potable supply derived  
3 from the Europe Economics Report, which is to be found at bundle 35, tab 47. I am not  
4 proposing that we turn it up. It is 1.19. Its volatility is – I know it appears that way from a  
5 graph that is set out in the final report – arrived at by a sensitivity analysis on volatility. It  
6 is not just depending on the trend. One needs to look at the Europe Economics Report,  
7 which is the basis of our conclusion. It is their recommendation and they explain how they  
8 have arrived at the adding of 3 per cent to the starting point which was Welsh’s regulated  
9 costs of capital set in the 1999 periodic review. That adds up to 7.75 which, when  
10 converted into a pre-tax, is the 11.1 per cent. We hope that is all explained as set out at p.72  
11 of the final report.

12 Treatment weighting: you will recall the point Mr. Thompson was making yesterday was  
13 that should have stuck to the original weighting that was based on the 12 systems and not  
14 included all the little non-potable systems when identifying an appropriate weighting for the  
15 potable. This is a point that we set out at length in annex 2 to our response, and at para.7 of  
16 that response we explain that we think it is necessary in order to get an accurate figure for  
17 the weighting to look at all potable treatment works in order to get a full picture to identify  
18 an appropriate weighting for potable treatment. That is why we looked at them all, and that  
19 is dealt with at annex 2 to the response, bundle 40, tab 6.

20 Item (s), the raw water MEAV: that is the same point as has arisen in earlier issues about  
21 using the lower Welsh incomplete MEAVs addressed in annex 1 to our response, tab 40.

22 Item (t) I understand has gone.

23 Storage MEAV is item (u). It is true that we approached these in a slightly different way,  
24 and that is simply, and I will be frank about it, because we ran out of time. We have  
25 explained fully at pp.62-64 of the schedule what we have in fact done. In so far as Albion’s  
26 criticism relates to what I would call the MEAV inflation point, again that is the same point  
27 we make in annex 1.

28 Item (v), the IRC: the argument here is, “Why did you use 120 years when your LAC and  
29 LRIC calculations are not the 180 years derived from the AAC calculation?” The short  
30 answer is because the 180 years is simply because we looked at the specific renewal  
31 expenditure in the actual year 2000/01 for the purposes of the AAC calculation. When one  
32 was looking – and of course the actual spending can fluctuate from year to year – at it and  
33 approaching in the context of the LAC and the LRIC the important exercise to undertake  
34 was what would be the appropriate average figure to take. Merely because expenditure had

1 been at that level in 2000/01 it may have been given an incomplete figure, so we used  
2 industry averages. That is explained at p.67 of the schedule, p.144 of the report.  
3 Storage weighting has gone, that is item (w). Item (x), gross or net MEAVs is no longer a  
4 point.

5 Next the MEAV for the water main. We have set out at some length in our skeleton the  
6 points arising out the Mott Macdonald report. The calculations were in fact based on three  
7 to four metres. It was a typo, the four to five metres. The most important point is that we  
8 did not actually use the MEAV figures from Mott Macdonald in our calculations. We used  
9 a lower figure and whatever errors there were in their calculations, even allowing for the  
10 percentage uplifts (which is the principal point that Mr. Thompson makes) we still get to a  
11 figure in excess of the figure we in fact used - in other words, we use the lower figure. In  
12 point of fact, we did make an adjustment for the uplifts. We only did it for two for some  
13 reason, and not all three, but the overall figure still does not bring us down to the figure we  
14 in fact used. The depth we in fact used was 1.6 metres, which is 900mm to the crown of the  
15 pipe and 1.6 metres if you got the bottom of the pipe.

16 THE CHAIRMAN: So, is there now any difference between you and Mr. Thompson on this  
17 point?

18 MR. ANDERSON: There may well be a difference in terms of what the calculations are, but the  
19 point is that whatever that difference is, it does not make any difference to the result  
20 because we did not use the Mott MacDonald figures for anything other than a cross-check.

21 THE CHAIRMAN: That is why I asked the question as to whether actually there is anything  
22 between you -- whether this is an item which we can ignore now.

23 MR. ANDERSON: Well, we would certainly say it is. We say it is a complete red herring.

24 THE CHAIRMAN: The answer is, 'No', is it? There is still something there?

25 MR. THOMPSON: There are a number of points that we make under that heading. This dispute  
26 has petered out to some degree in a degree of agreement, although we have made some  
27 points about discrepancies between, "They are all water pipes and potable pipes -- non-  
28 potable pipes" which at the moment I have not heard any answer to -- why the same  
29 specification gives rise to a figure two and a half times as high for non-potable pipes of  
30 exactly the same specification as raw water pipes. We have got various comparators which  
31 we find unconvincing.

32 THE CHAIRMAN: The thing about the depth is no longer ----

33 MR. THOMPSON: We hear what we are being told. We have still had no explanation as to why  
34 it costs two and a half times as much for the very same pipes, depending on whether there is

1 non-potable or raw water going through them, given that that water is very much the same.  
2 They have been told it should be all the same.

3 MR. ANDERSON: The short answer to that is that this is one of the new points in his schedule  
4 which has not been made anywhere before in the comments on the final report, and takes us  
5 by surprise. We will look at it if the Tribunal wishes us to, but this is a point of fact that  
6 arises out of this fax which we got a couple of days ago. The figures are not set out  
7 anywhere so far as we are aware in the comments on the final report.

8 MR. THOMPSON: It is actually in our reply in response to their skeleton received last Friday.  
9 So, I do not think there is much point in there.

10 MR. ANDERSON: Well, for the first time a couple of days ago, whichever document it is in.  
11 Rates - Item Z - whether they should be apportioned according to MEAV of profits. That is  
12 a debate which we have been having with Albion since the outset of this case. It is a matter  
13 of judgment. We have taken the view we have taken because their rates are calculated on  
14 the basis of profits. That is p.173 and pp.88 to 89 of the schedule.

15 LRIC - the first main criticism is: Why did you not do an industry-wide LRIC? Two  
16 reasons: (1) We do not believe it would have served much of a useful purpose; (2) it would  
17 have been a colossal amount of work to start doing LRICs in respect of ten discrete non-  
18 potable systems. There is a limit to the amount that we could have done in this exercise.  
19 The second criticism is the 20 percent increment, which I have dealt with, as has Mr. Vajda.  
20 The 17<sup>th</sup> March letter I will deal with very briefly at the end - this is the Item BB - the  
21 contemporaneous letter.

22 Item CC - the status of the report. I have dealt with that.

23 Item DD - LAC. Albion's criticisms of what we have done in the report have rather run out  
24 of steam by that stage of the schedule. Such points as there are made, both by Albion and by  
25 Welsh, are dealt with in the schedule. I have nothing I wish to add to it.

26 The letter of 17<sup>th</sup> March - we have dealt with this in our skeleton argument. The short point  
27 is that we confirm that in February 2003 we asked Dŵr Cymru to investigate the possibility  
28 of developing what it has called its 'third party envelope', which, according to our  
29 accounting guidelines, should include an estimate of non-potable operating capital  
30 maintenance costs as a means of cross-checking the company's AAC original methodology.  
31 This work was presented under the heading of 'additional information' in the letter of 17<sup>th</sup>  
32 March. The Authority confirms that at the time it placed little weight on the results of this  
33 third party service cross-check as it had a number of reservations. Indeed, the criticisms we

1 had of what was called Methodology 1 originally before the Tribunal were applicable --  
2 They were the same criticisms.

3 The reservations we had were as follow: (1) as Albion itself points out, this included a  
4 particularly high contribution to Dŵr Cymru 's common costs; (2) we were not convinced  
5 that allocating third party service costs on the basis of volume leading to a 15.3 percent  
6 weight was robust; and (3) we were aware that the 85 million gross MEAV estimate  
7 provided by Dŵr Cymru only related to the raw water aqueducts and non-potable mains,  
8 and therefore excluded a return on all water resource, water pumping, water storage, water  
9 treatment and control and telemetry assets. We now understand that a range of other  
10 operating costs relating to shared operational control facilities and sludge disposal were also  
11 not included in this third party cross-check.

12 So, for a number of reasons we did not regard what was in the letter of 12<sup>th</sup> March as  
13 reliable. So, the figure of 7.86, which you recall Mr. Thompson placed some weight on, we  
14 did not rely on. It is not helpful, and we say it is irrelevant to the work we undertook in the  
15 final report.

16 That brings me to the second limb of the *United Brand*'s test. We only get to this issue if  
17 there is some excess over costs. We found that there was some excess, and it could not be  
18 dismissed as **de minimis**.

19 THE CHAIRMAN: Did you find that it was excessive in the sense of *AtTheRaces*?

20 MR. ANDERSON: Yes.

21 THE CHAIRMAN: It was significantly in excess.

22 MR. ANDERSON: In the sense of *AtTheRaces*? We found it was sufficiently material to justify  
23 going on to the second limb: Was it unfair in itself or by ----

24 THE CHAIRMAN: The first test is: Is it excessive? *AtTheRaces* said 'significantly in excess of'.

25 MR. ANDERSON: Yes.

26 THE CHAIRMAN: Is that what you meant by 'material'?

27 MR. ANDERSON: I am not sure that we have phrased it in quite exactly the *AtTheRaces* way.

28 THE CHAIRMAN: No. Was *AtTheRaces* after?

29 MR. ANDERSON: No, it was before. I think we phrased it by reference to the test of *United*  
30 *Brands*. That is the exercise we went through. We found there was an excess of costs ----

31 THE CHAIRMAN: -- which you said was material, and then you went on.

32 MR. ANDERSON: We asked ourselves essentially in two stages: Was there an excess over  
33 costs? Answer: Yes. Was it material? Answer: Yes. Therefore, it was excessive in that

1 sense, requiring us to go on to decide whether that was unfair in itself or by reference to  
2 comparisons.

3 THE CHAIRMAN: So, you did find that it was excessive in the meaning attributed to 'excessive'  
4 in *United Brands*.

5 MR. ANDERSON: Yes. That is what we found.

6 PROFESSOR PICKERING: It was such as to trigger the Stage 2 consideration?

7 MR. ANDERSON: Yes. Yes. That is what we found. Now, on our figures - and I know Mr.  
8 Thompson keeps saying 'our figures show a 44 percent' -- That is only because he is taking  
9 out the back-up supply. We approached it on the basis that the excess was around 20  
10 percent.

11 Now, we looked at all these externalities that had been advanced in the course of the  
12 referred work. We considered them, and they are dealt with at considerable length in our  
13 final report. We also looked at the comparators that were suggested to us. The view we  
14 took - and again we have set it out very fully in our final report for the assistance of the  
15 Tribunal because, as I say at the outset, "This is not a decision; this is work we have done  
16 for you" -- We have set out at length the comparators and the figures. We have set out at  
17 length the externalities. The view we took was that with the comparators, there are too  
18 many problems in trying to compare like with like for these comparators really to assist.  
19 Most of them related to retail prices and therefore were not a sensible approach for  
20 comparing access prices, because one would need to make various adjustments for water  
21 resources, and so on. Or, if there are other areas, because the nature of these systems are so  
22 discrete, it is going to be very difficult to embark on an exercise of doing costs adjustments.  
23 The idea of entering into the sort of exercise we entered into identify the relevant costs for  
24 this system -- to do it to other systems to see if they make a sensible comparison -- We just  
25 did not believe that comparators would get us anywhere. The result of that, of course, is  
26 that we did not find that these prices were out of kilter with comparable prices - not because  
27 we thought that they were in line with them, but simply because, in our view, there were not  
28 relevant comparators. So, we went on to consider: Was the price unfair in itself? We could  
29 find no relevant externality that would indicate some alternative measure of the economic  
30 value than a margin in excess of the cost. That is what we looked at. We looked at *Deutsche*  
31 *Post* and there they said 25 percent to 40 percent. This was below 25 percent, and so the  
32 view we took was that there is insufficient evidence that this excess was unfair in itself.  
33 It is true that in the Court of Appeal in *AtTheRaces* overturned Mr. Justice Etherton on the  
34 grounds that he had taken too narrow a view of economic value by using a cost-plus

1 approach. But, the reason they did that was essentially two-fold: (1) there were an awful lot  
2 of indirect costs which one could not quantify (effectively the costs of supporting racing in  
3 the country); and (2) there was valuable onwards sales market which generated a lot of  
4 money. Therefore one could sensibly identify as an economic value the value out in the  
5 market place.

6 We say those sorts of considerations do not apply in this case. The position we found  
7 ourselves in - and, as I say, it is ultimately a decision for you - is that the only sensible  
8 approach in this case is to identify, as the economic value, some margin in excess of costs  
9 because there was nothing else we could use. In our submission, properly read, cases such  
10 as *Scandlines* and *AtTheRaces* do not say that costs-plus could never be the economic  
11 value". They simply say, "It isn't necessarily the economic value. It is certainly a starting  
12 point. It is not a rule of thumb that is used in every case". But, in this case we did look at  
13 everything else and came to the view that there was really no other way of doing it in a case  
14 like this.

15 That completes my submissions unless I can help the Tribunal further.

16 Professor Pickering did have some questions. I have done what I could. It may be that the  
17 sensible course is for the Tribunal to send us the questions and for us to respond to them in  
18 writing.

19 THE CHAIRMAN: You have got the questions.

20 MR. ANDERSON: I got an indication.

21 THE CHAIRMAN: You will have the transcript.

22 MR. ANDERSON: We can take them from the transcript. One point was: Why do we use  
23 volume rather than revenue for the purposes of our costs allowances? The short answer is  
24 because when one is looking at allocating costs with a view to assessing whether a price is  
25 excessive, one wants to take price out of the equation and, of course price is in the equation  
26 for revenue because it is just volume multiplied by price.

27 PROFESSOR PICKERING: The consequence of that is that there is an advantage on that basis to  
28 those who pay the higher price.

29 MR. ANDERSON: That may be so but ----

30 PROFESSOR PICKERING: Well it flows from price x volume = revenue.

31 MR. ANDERSON: You may be right but of course the logic of not doing it by price is that you  
32 need to take price out of the equation if the price that is at issue is part of your assessment,  
33 your allocation, the investigation will be circular; that is why we did it.

34 PROFESSOR PICKERING: I hear you.

1 MR. ANDERSON: Throughput capacity: obviously people only pay for the water that they use  
2 and if you considered or allocated by reference to total capacity rather than throughput you  
3 would be having an element of costs for which there was no revenue.

4 PROFESSOR PICKERING: In the short run.

5 MR. ANDERSON: Yes, well as I say, that is why we do throughput rather than capacity.

6 PROFESSOR PICKERING: That removes the incentive to improve capacity utilisation.

7 MR. ANDERSON: That may be right but again I urge the Professor to come back to the point we  
8 are looking at in this case, which is: Was Welsh's price so in excess of its costs as to justify  
9 a finding of unfairness? We are not in this exercise engaged in regulating prices. That is  
10 not the function of Article 82.

11 How do we justify using a figure higher than the opportunity cost? We say the opportunity  
12 cost is simply greater because of the fact that we have disaggregated – it is the same point as  
13 the disaggregated debate that we were having earlier.

14 Double margin because United Utilities is subcontracted. I think our point is that if Welsh  
15 had taken the view that it is cheaper and more efficient to use United Utilities as a  
16 subcontractor then the costs are the costs it pays United Utilities and of course that may well  
17 include a profit margin for United Utilities but that is no different than anybody else who  
18 hires a subcontractor – you pay them whatever it is that you have negotiated.

19 PROFESSOR PICKERING: So what you have used is cost information provided to you by Dŵr  
20 Cymru?

21 MR. ANDERSON: Yes.

22 PROFESSOR PICKERING: Thank you.

23 MR. ANDERSON: Treatment costs: why had we not paid heed to the guidance the Tribunal  
24 previously gave to us? No disrespect meant, we simply went back to scratch and looked at  
25 things from the start. Now sludge removal is included, that was not addressed before, and  
26 so it is looking at it anew, fresh evidence, that is why the figure is different. That is about  
27 as far as I got, Professor, in answering your points, if there are any others I have missed? I  
28 am conscious there is one about ----

29 THE CHAIRMAN: You were going to check it on the transcript – you are going to check your  
30 answers on the transcript and then you can write whatever the balance is.

31 MR. ANDERSON: Yes.

32 PROFESSOR PICKERING: Could I say “thank you”? You and your colleagues obviously had  
33 an interesting lunch break?

34 MR. ANDERSON: We had a lovely lunch, thank you, Professor, yes.

1 PROFESSOR PICKERING: Not at all.

2 THE CHAIRMAN: There was some suggestion that you might be getting up after this, but you  
3 do not look like you are – is that right? How long do you think you are going to be? I do  
4 not want to cut you.

5 MR. THOMPSON: I think we will comfortably finish – is it a question of whether we should  
6 have a short break before I do?

7 THE CHAIRMAN: Yes.

8 MR. THOMPSON: I would be quite happy by that; I am sure we will finish by half past four.

9 THE CHAIRMAN: You are sure you will?

10 MR. THOMPSON: Oh yes.

11 THE CHAIRMAN: Five minutes then. Thank you.

12 (Short break)

13 MR. THOMPSON: Madam Chairman, there are enough problems in this case, but I am glad I am  
14 able to solve one of them quickly and cleanly, namely the legal conundrums set us  
15 Mr. Randolph as to whether it is possible to be both a competitor and a customer.  
16 Mr. Randolph did not have the advantage of being in the Court of Appeal, otherwise he  
17 might recall the *IPS* case which was in fact mentioned in this case and played a fairly  
18 prominent role there. The facts are best summarised at para.298 of the further judgment.  
19 Shall I read it out?

20 “In the *IPS* case PEM, part of the P echiney Group, produced primary calcium  
21 metal and broken calcium metal which was derived from primary calcium metal.  
22 PEM sold primary calcium metal to IPS, which produced and sold broken calcium  
23 metal in competition with PEM on that downstream market. IPS complained to the  
24 European Commission that PEM was trying abusively to exclude from the market  
25 for broken calcium metal in various ways, including ... excessive pricing of  
26 supplies of primary calcium metal, and imposing a price squeeze in the market for  
27 broken calcium metal.”

28 So in that case IPS was a competitor and a customer and ran two complaints very similar to  
29 these. I think that probably concludes that. That is, of course, a binding authority on this  
30 Tribunal and indeed on any court in the UK under s.60 of the Competition Act.

31 Turning to Mr. Vajda’s points, if I may say so, it appeared to us that it was a somewhat mild  
32 set of submissions and that none of his positive points were put forward, which to us  
33 suggested that he did not have any great confidence in them. I may be mistaken. He mainly

1 seemed to have procedural issues and one defensive point about the back-up supply, though  
2 I will obviously come to the abuse in due course.

3 In relation to procedural issues, we would say that his position was clearly wrong. His three  
4 options are not exhaustive. In our submission, it is clear that the Tribunal referred the  
5 matter back as a way of generating more information, the approach in the interim judgment  
6 having failed to elicit the information required. It is quite clear that the Tribunal had and  
7 retained jurisdiction to determine the matter on all the evidence in accordance with  
8 Schedule 8 to the Act.

9 Turning to the regional and local point where some amusement was caused, at least to their  
10 own supporters, by pointing out that it was advantageous to us to take a regional rather than  
11 a local approach, and that that was inconsistent with our earlier approach. I could perhaps  
12 just remind the Tribunal of the position we have adopted since the notice of appeal, which is  
13 found at bundle 1, p.21. It is para.143. In fact, it is referring back to a letter from, I think,  
14 Eversheds in May 2002, but this is 2004:

15 “In order to simplify resolution of the case Albion Water agreed to accept an  
16 access charge based on either regional or local costs as long as it fairly reflected  
17 Ofwat’s policy on charging, i.e. the costs incurred.”

18 So that has been our position throughout these proceedings.

19 In my submission, the approach of the Tribunal has been clear since at least the interim  
20 judgment and one can find that in various places in the main judgment, but perhaps it is  
21 convenient ----

22 THE CHAIRMAN: Can I just ask you, what is meant by “as it fairly reflected Ofwat’s policy on  
23 charging”, because Ofwat’s was not to use either of those?

24 MR. THOMPSON: As I understand it, the position is very much as I have advanced in opening,  
25 that the approach must be a fair one. We made various suggestions as to how it should be  
26 done. To suggest that there has been some radical change of position on this point -----

27 THE CHAIRMAN: I understand that. I am just looking at this.

28 MR. THOMPSON: I think, without going into the detail of the various methodologies, which I  
29 suspect none of us want to do at this stage, it is difficult to reopen it. I was simply replying  
30 on that narrow point just to remind the Tribunal of where this has all come from.

31 Turning to the position as in the interim judgment, that is set out conveniently in paras.260-  
32 265 of the main judgment. You will that 260 refers to our challenge to the “whole  
33 company” average accounting approach. Then 261 gives issues under (a) which were to be  
34 addressed in relation to that, in fact (a) to (i). Then 263 is the separate issue.

1 I should perhaps give the heading. The heading is “(i) Deriving non-potable costs from  
2 ‘whole company’s costs: the distribution element”. That was the first approach. Then the  
3 second one is “The costs of the Ashgrove system”. Then there is a reference:

4 “In the course of the first hearing Albion relied, in what was then known as its  
5 fourth method ...”

6 - and I think Mr. Vajda took you to that but omitted the word “fourthly”, and I think tried to  
7 imply that that was our first method. There has actually been the same approach  
8 throughout, but there has been an approach based on general costs which we have criticised,  
9 and then there has been the issue of whether or not you can use a cross-check based on  
10 “bottom-up costs”. You can see that at para.265:

11 “The Tribunal did, however, accept that an calculation of ‘bottom-up’ costs (i.e.  
12 starting with the costs of the Ashgrove sys, as distinct from the Direct’s ‘top-down’  
13 approach, which was to consider Dŵr Cymru’s costs on a ‘whole-company’  
14 approach and work down from there) ...”

15 Then there are various references to the cross-check issue. For example, 268 sets out how  
16 the matter is to be conducted under paras.427(a) and (b). There is the general position; and  
17 then (b):

18 “... to consider whether it is necessary or practicable as a cross-check to consider  
19 the stand-alone costs of the supply of non-potable water on a bottom-up basis ...”

20 So it was there. It is also at 565, 566, 606, 608, but perhaps the most convenient is  
21 para.470.

22 “In our view, there is nothing intrinsically inappropriate in a ‘top-down’ approach  
23 to establishing average accounting costs, assuming reliable information and proper  
24 accounting procedures. But any such ‘top-down’ approach needs to be subject to  
25 appropriate verification.”

26 Then there is a particular reason. Then at the bottom:

27 “The obvious cross-check in such a context is a ‘bottom-up’ calculation.”

28 In my submission, this has been the approach. It is perfectly true that our clients, certainly  
29 at an initial stage, criticised the first access price in part by reference to local costs, but  
30 throughout this appeal it has been recognised that there is the top-down approach and the  
31 bottom-up, and the Tribunal has consistently characterised the local approach as the cross-  
32 check and has accepted the regional average as the starting point. So that was the point we  
33 were making.

1 In relation to back-up, Mr. Anderson sought to distinguish between the service of  
2 transportation and distribution and transportation and distribution. In my submission, that is  
3 a distinction without a difference. It is a lawyer's distinction rather than a distinction of  
4 substance. When one thinks about what the back-up supply is, it is, in fact, a potable  
5 resources with potable treatment and potable distribution. It is not reasonable to attribute it  
6 to non-potable treatment and non-potable distribution, particularly when the water comes  
7 from an entirely different source. In my submission, it is not the same service, and it is not  
8 part of that service and it is not reasonable to attribute it to that service.

9 One can test that when one compares it to the issue of the sludge disposal and, as I  
10 understand it, the Ashgrove system is the only system that actually has sludge disposal  
11 costs. There are only two systems that have treatment at all, and the Cork Farm actually  
12 disposes of its sludge along with its potable sludge, and so it does not have any separate  
13 sludge disposal. Yet that figure is held within the regional average. You ask yourself why  
14 that it is. It is because sludge disposal is part of the function of the treatment and is properly  
15 to be attributed to the function of treatment.

16 Why is it that back-up is not treated in the same way? The reality is that it is a completely  
17 different service.

18 I think it is Ernest Bevan who said, "Why look in the crystal ball when you can read the  
19 book?" I think there has been some reference to what has been said by various people and  
20 what people meant, but in fact we do have the Bulk Supply Agreement itself in the papers,  
21 in bundle 2, tab 9, and I think it is worth just looking at that. It is at p.13. As I understand  
22 it, although the agreement is dated 1999 and its term was for four years, it has been given  
23 effect continuously until now, subject only to the interim measures that have been adopted  
24 in this case. You will see it starts at p.13 of tab 9, and is dated 10<sup>th</sup> March 1999. When you  
25 look at the substantive provisions, clause 1 is the supply of non-potable water, so that is the  
26 clause that would have been rendered obsolete by the Common Carriage Arrangements  
27 because Dŵr Cymru would no longer have had to supply water. It would only have had to  
28 supply treatment and transport services.

29 Paragraph 2, the supply potable water, 2.1 says that Dŵr Cymru shall supply such quantity  
30 of potable water to Albion Water as it may require during the term of this agreement up to a  
31 maximum quantity of 8 MI/d which maximum quantity Dŵr Cymru shall reserve for such  
32 supply. So that is the potable obligation. It is not separate from the back-up supply, it is  
33 simply a potable obligation up to 8 MI/d. There is, in fact, a provision for an additional  
34 amount under clause 2.2.

1 Then, when one looks at the charging, you find under 4 the charging arrangements, that  
2 non-potable water will be charged at 26p per cubic metre supplied, and so that clause would  
3 obviously have had to have been replaced with the entry into force of the Common Carriage  
4 Arrangements.

5 The arrangements in relation to potable water, potable water will be charged at 59p per  
6 cubic metre supplied, so there was no distinction between the water depending on whether  
7 or not it was additional water for the works, as it were, or the canteen. It was simply  
8 potable water.

9 Then 4.3 is the paragraph that I think Miss Cross is referring to in her statement to the  
10 Authority:

11 “In the event that Dŵr Cymru is unable to supply a minimum of 18 MI/d of non-  
12 potable water for a period exceeding 24 hours, it can only supply potable water  
13 taken by Albion Water to make up the shortfall in the non-potable supply below to  
14 a reservation of 80 MI/d, will be charged at the non-potable rate current at that  
15 time.”

16 So that is all there was by way of back-up, but I believe that there were very few occasions  
17 on which back-up was ever used in reality. The bulk of the water was supplied under 4.2  
18 simply as part of the potable water.

19 THE CHAIRMAN: 2.2, the last sentence, says that the availability of the additional quantity of  
20 water is not guaranteed and DCC will be under no duty to supply it.

21 MR. THOMPSON: Where are we?

22 THE CHAIRMAN: At 2.2, last sentence.

23 MR. THOMPSON: Yes, that is the amount over the 8 MI/d.

24 THE CHAIRMAN: Yes, absolutely, and you have got mega-litres there, and you have got 18 in  
25 4.3.

26 MR. THOMPSON: Exactly.

27 THE CHAIRMAN: That seems odd.

28 MR. THOMPSON: 18 is the Paper Mill, what has been said to be equivalent to a medium sized  
29 town. So that is the non-potable water that is required. That guaranteed potable was about  
30 a third.

31 THE CHAIRMAN: They have no duty to supply non-potable above 8?

32 MR. THOMPSON: That is right.

33 THE CHAIRMAN: If they are unable to supply 18 of non-potable, then they are going to make  
34 up the shortfall?

1 MR. THOMPSON: That is right. I think 8 Ml/d is still a very, very large amount of water. It is  
2 enough for a small town. That could be produced daily. I think that is the back-up supply  
3 in reality, but it is also, in fact, a top-up supply. So if we want to use more than 80, or if the  
4 mill wants to use 80 Ml/d, say it wants to 22, as I believe is not entirely unusual, then it can  
5 have 4 Ml/d, but it pays for it as potable water, as if it was drinking it out of a glass.

6 THE CHAIRMAN: It is just the wording at 4.3, which does not quite fit with that last sentence at  
7 2.2. You explained the 8 and the 18. It does not matter.

8 MR. THOMPSON: I think it simply limits the obligation, so that there is no obligation above the  
9 8 Ml/d.

10 The other point that I think is worth looking at appears at tab 7 of this same bundle, which is  
11 Ofwat's commentary on, I think, the predecessor of this agreement in relation to Albion's  
12 inset application. It is a letter from Ofwat to Dr. Bryan, and there is a reference at the  
13 bottom to how the price is calculated. Over the page it says:

14 "The recommendation will avoid setting fixed charges. The tariff structure under  
15 which Shotton Paper currently pays for potable water is designed to create a  
16 disincentive to waste water. Several other companies also use this structure.

17 However, in this case the customer has no incentive to waste water and therefore a  
18 fixed charge is clearly unnecessary."

19 So, as I understand it – I am sure Dr. Bryan understands it very well – the position is that  
20 the water has been supplied, the back-up has been provided at cost on a unit basis without a  
21 fixed charge since 1999. So when Albion Water said they wanted things to carry on as  
22 before they were not envisaging some whacking great fixed charge to be included in the  
23 fixed access price. They were saying that this perfectly sensible arrangement could  
24 continue and that is why they are particularly unenthusiastic about paying a fixed charge of  
25 £1 million to Dŵr Cymru on some replacement to this Bulk Supply Agreement. So, in my  
26 submission, that contract is highly relevant both to the fact that this is actually a potable  
27 supply which is quite distinct from anything which was being considered under the first  
28 access price and also as to the question of quantum.

29 So that is my submission on back-up supply.

30 I have one other point on the back-up supply which is its relationship to regional averaging.  
31 If the back-up supply were included at all, contrary to these submissions, then it does appear  
32 to me that on the logic of the Authority's approach it ought to be charged equally across all  
33 the non-potable systems, and if that is not thought to be appropriate that merely illustrates

1 the absurdity of the Authority's position suggesting that other non-potable systems should  
2 share in the potable supply costs of Dŵr Cymru to Ashgrove, or indeed to Shotton.

3 The other point in relation to LRIC is a similar point: if the Authority is correct and the  
4 back-up supply should be included as part of the LRIC cost, then it is a zero cost because it  
5 is not incremental. It should not then be added on the top. It seems to me quite illogical to  
6 say that the back-up supply is part of the service, to value it at zero, and then say, "But,  
7 nonetheless, 4.4 should be added on afterwards". In my submission that simply does not  
8 hang together and again illustrates the absurd nature of the Authority's position on the back-  
9 up supply.

10 Mr. Vajda handed in a note where he took issue with us on LRIC and LAC, and said that we  
11 had not got much of a point on either. I think the point on LRIC is essentially that it is no  
12 better than the stand-alone calculation. It is not a useful way of evaluating what the costs are  
13 here to speculate on what might be necessary if the value is increased. It is really just not a  
14 useful cross-check of any kind.

15 In relation to LAC the other side are perfectly correct. We have no objection to a local  
16 accounting costs system in principle. We have been asking for it for a decade. It is a  
17 question of how it is conducted. We say that the values are wrong.

18 Mr. Vajda mentioned the issue of approval - seeking approval from Ofwat. Whether  
19 or not they sought it, they did not get it. Here we are, contesting whether the price  
20 was abusive. So, it does not seem to me to take the matter any further.

21 In relation to *Skandlines*, again, I do not think Mr. Vajda's buckets were quite right. He  
22 said there were two buckets - one for the costs of the service and one for the benefits  
23 attributable to the service but not capturable in costs. In my submission, Madam Chairman,  
24 you are perfectly correct - there is a third bucket, namely costs which are not attributable to  
25 the service. In my submission the back-up supply would be a good candidate to go in that  
26 third bucket.

27 So far as non-cost factors are concerned, I think happily we seem to be in agreement with  
28 both Dŵr Cymru and the Authority. In principle non-cost factors should be taken into  
29 account, but the type of economic cost factors that Professor Pickering identified - and Mr.  
30 Vajda agreed with - we agree with the Authority that there are none here. What we do say  
31 is that there are other non-cost factors of the kind we identified in Part D of our  
32 submissions, and which we say represents standard principles under Article 82 and the  
33 Chapter II prohibition, which we say are very much in issue, and in particular the relatively  
34 low profitability of this business and the gargantuan market share of that profitability taken

1 by Dŵr Cymru, which we say is very much something which the Tribunal should take into  
2 account in looking at the level of excess in this case.

3 I think Mr. Vajda tried to suggest that *Deutsche Post* had been overridden or superseded in  
4 that *Skandlines* was binding. Neither of those propositions is correct. They are both  
5 decisions of the Commission. There is nothing in *Skandlines* to suggest that *Deutsche Post*  
6 was wrong or over-written in any way. Both of them are decisions of the Commission,  
7 which, under s.60, para. 4, the Tribunal is bound to take account of, but is not bound by. So  
8 they are, as it were, on an equal footing.

9 In relation to the burden of proof, we would not presume to add to the learning of the  
10 Competition Appeals Tribunal on this. I am sure it is a subject on which the Tribunal is very  
11 well able to make up its mind. The only point I would add is that it might be worth just  
12 reminding ourselves of the *United Brands* facts, and why the burden of proof was not  
13 discharged in that case. I do not know if it is necessary to turn it up. The point was that the  
14 Commission had done no investigation of costs whatsoever, but had observed that the price  
15 in Ireland was very low and the price in other countries was rather higher, and had inferred  
16 from that that the price in the other countries must be excessive. The Court of Justice did  
17 not find that sufficient proof, but it does not seem to me that that casts much light on  
18 whether or not the evidence in this case is sufficient to constitute sufficient proof. In my  
19 submission it is.

20 I think I have only got two more points, and I think I can get them done in four minutes.  
21 The first is stranded assets. Simply to reiterate the position that I put forward before -  
22 although we have accepted them in principle, we have not done it with a very light heart.  
23 We see considerable source in Professor Pickering's objections. In any event, we have our  
24 objections to the approach to costs of capital, MEAVs and the fact that the Welsh  
25 Development Agency was largely responsible for the costs of the major stranded assets. So,  
26 we do not think the valuation is correct.

27 The last point relates to our note. Looking at it, as far as we can see, there are only two  
28 points which might be regarded as new. Paragraphs 31 to 32 in relation to regulatory  
29 services, which I think takes 0.1 pence off the AAC-plus figure, and a point at paras. 55 to  
30 57 in relation to general and support services which takes 0.9 pence off the LAC figure.  
31 The effect of adding those back on would be to produce AAC-plus figures of 7.8 pence and  
32 LAC figures of 7.6 pence, which would average at 7.7 pence, which is the figure which we  
33 gave for AAC-plus. So, in my submission it is not a very material issue if we have changed  
34 anything. In any event, it appears to us that it is really a rather remarkable approach for a

1 very large company and a public authority to wait until the hearing was supposed to have  
2 finished before raising these points. They could have raised this point on Tuesday,  
3 Wednesday, or Thursday. We produced it very rapidly, and we do not see any reason why  
4 those bodies could not have acted more quickly. In any event, there is nothing actually new.  
5 Figures of this kind have been exchanged between the parties in the context of the back-up  
6 supply debate which has been going on since November. So, we see no particular merit in  
7 the complaint, even as a matter of substance.

8 Those are our submissions. Unless there are any more questions for me, we are done with a  
9 minute to spare.

10 MR. VAJDA: I am in the Tribunal's hands as to the questions that Professor Pickering asked me  
11 earlier on today. There is also one small point that I would like to raise in relation what was  
12 said in relation to Mr. Jones's witness statement, and then I would like to come back very  
13 briefly on the bulk supply agreement point because I have not made any submissions on the  
14 agreement – I can do that in writing or I can do it orally – I have just three small points on  
15 that.

16 THE CHAIRMAN: I would have thought that Professor Pickering's questions could be done in  
17 writing, I think that is probably the easiest way to deal with those.

18 MR. VAJDA: Yes.

19 THE CHAIRMAN: So you have two points.

20 MR. VAJDA: Well the other minor point I will do in writing, and can I just deal with the bulk  
21 supply? I would like to take the Tribunal, if I may, to the final report at p.85. I have three  
22 points on this agreement. At p.85 you will see a figure and below that in fact the back-up  
23 supply has been used on 60 occasions between May '99 and August 2004, and it was in fact  
24 used – there was an outage, the pipe at Shotton went down in 2005 and that is what figure 1  
25 shows, and that was provided under the bulk supply agreement, and the passage that you,  
26 madam Chairman, ... in the agreement was 2.2 – the availability of the additional property  
27 of water, that is to say over and above eight. So that is point 1.

28 Point 2 is that there is plainly a cost to this – we have been in to this.

29 Point 3, which is the point in reply to what Mr. Thompson said, which is actually it  
30 concerns the supply of potable water, so it is not relevant; it is not reasonably necessary for  
31 the transport and distribution of non-potable water. Can I just ask the Tribunal to take up  
32 again, and this is my last point on that – p.41 of the final report - at 5.43:

33 *“[Malcolm Jeffery] stated that he envisaged the maintenance of existing*  
34 *arrangements with DCC i.e. potable back-up.”*

1 That was the point that Mr. Anderson was making, that in the special circumstances here  
2 you needed potable back-up. The same point was made I think by Dr. Bryant, or one of Dr.  
3 Bryant's colleagues, at the meeting with Ofwat on 18<sup>th</sup> May 2007 at para. 5.45: "*No getting*  
4 *away from it; Albion needed a potable supply.*" I accept it is potable but the point is – and  
5 that is the point that Mr. Anderson made – that in this particular situation there was a need  
6 for a back-up and the back-up was potable.

7 That is all I have to say.

8 THE CHAIRMAN: Any thing else? Can I thank you all for your submissions and I think they  
9 were very, very helpful as was the written material that had been provided beforehand, and  
10 in due course you will know the result.

11 \_\_\_\_\_  
12