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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1046/2/4/04

Victoria House,
Bloomsbury Place,
London WC1A 2EB

30th May 2006

Before:
SIR CHRISTOPHER BELLAMY
(The President)

THE HONOURABLE ANTONY LEWIS
PROFESSOR JOHN PICKERING

Sitting as a Tribunal in England and Wales

BETWEEN:

ALBION WATER LIMITED

Appellant

Supported by

AQUAVITAE (UK) LIMITED

Intervener

-v-

WATER SERVICES REGULATION AUTHORITY
(Formerly The Director General of Water Services)

Respondent

Supported by

DWR CYMRU CYFYNGEDIG
and
UNITED UTILITIES WATER PLC

Interveners

Transcribed from the Shorthand notes of
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 ONE

APPEARANCES

Mr. Rhodri Thompson QC and Mr. John O’Flaherty, instructed by Albion Water Limited appeared on behalf of the Appellant.

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

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 the Group Legal Manager, United Utilities) appeared on behalf of United Utilities.

1 THE PRESIDENT: Mr. Thompson, before we start, the Tribunal would like, if it may, through
2 you to express its condolences to Dr. Bryan on the very sad and recent death of Mrs. Bryan.
3 We understand that it is the family's wish that these proceedings should continue
4 nonetheless as far as possible in accordance with the envisaged timetable.

5 MR. THOMPSON: Yes, I am very grateful. I think in fact it is not Mrs. Bryan, it is Mrs.
6 Bryan's mother.

7 THE PRESIDENT: I am sorry. I had misunderstood.

8 MR. THOMPSON: Yes, but I am very grateful for that, and that is the wish, although the funeral
9 is scheduled for 8th June, which may yet impact on this question.

10 THE PRESIDENT: Yes, thank you for that clarification. Now, what is the situation today?

11 MR. THOMPSON: Well, I have come here, or had come here on the basis that we were
12 proceeding today, but I have had recent information from counsel for the Authority that
13 there is an issue on their side, and it may be appropriate for Miss Sloane to explain what the
14 position is. As I understand it there is an application for an adjournment until this time
15 tomorrow, which we have no difficulty with as a matter of personal sympathy for Mr.
16 Anderson's position but, on the other hand, it probably would be sensible to discuss what
17 the implications are for the hearing in terms of whether we will get through the evidence
18 and whether any specific provision needs to be made, and things of that kind, but otherwise
19 it is probably appropriate for me to leave it to Miss Sloane.

20 THE PRESIDENT: Yes. Miss Sloane, our information is that Mr. Anderson has been injured in
21 an accident over the weekend.

22 MISS SLOANE: That is correct.

23 THE PRESIDENT: But that he is expecting to be able to start the case tomorrow?

24 MISS SLOANE: That is correct.

25 THE PRESIDENT: And you are applying, as I understand it for an adjournment until tomorrow?

26 MISS SLOANE: Tomorrow morning, yes.

27 THE PRESIDENT: I think we are anxious to do two things. One is to see whether there are
28 things that we can nevertheless usefully do today, and secondly to see how far we can make
29 a slightly more coherent plan for this hearing because, as I understood it, we need to sort out
30 in a little bit more detail who wants to cross-examine whom, how long it is likely to take
31 place and when we should have submissions and all that sort of thing, so we could perhaps
32 usefully do those two things together before we decide what we are going to do so far as
33 today is concerned.

1 MISS SLOANE: Certainly, in terms of the Authority's position today, the Authority found out
2 last night around 7 o'clock from Mr. Anderson that he had been in this accident. He was on
3 his way to hospital at the time to have an X-ray to check that nothing was broken. I spoke
4 to him again at half past ten last night, nothing was broken although he has been damaged.
5 He is in severe pain but he said last night, and the clerk again checked this morning, that he
6 considers that he will be in a position to be here tomorrow morning. Given the very late
7 notice the Authority is not in a position to day to make an opening statement, and nor is it in
8 a position to cross-examine.

9 THE PRESIDENT: Was it proposing to cross-examine?

10 MISS SLOANE: It was not proposing to cross-examine Dr. Bryan, but it was proposing to cross-
11 examine Mr. Jeffery.

12 THE PRESIDENT: Right. I suppose what is in our mind is whether it is convenient or useful to
13 at least get on with the cross-examination of Dr. Bryan. I mean, we are all here today.
14 Everybody has got the thing in the forefront of their minds. It is a pity to lose time if we
15 can avoid it.

16 MISS SLOANE: The Authority's preferred position would be for their leading counsel to be
17 present during the hearing of the evidence, particularly as he will be likely to be making
18 submissions on it, and the transcript will be a relatively poor substitute for that.

19 THE PRESIDENT: Why is a transcript a poor substitute?

20 MISS SLOANE: Because the Authority says that it is quite natural that seeing and hearing the
21 evidence for oneself is more effective than reading it.

22 THE PRESIDENT: Yes.

23 MISS SLOANE: Having lost one day, we are really in the hands of the other parties as to time
24 estimate, and whether we are actually going to lose anything or be pushed.

25 THE PRESIDENT: What is your general position about who you want to cross-examine; time
26 estimate; and all that sort of thing? I do not know if the parties have had any chance to
27 discuss it amongst themselves.

28 MISS SLOANE: There has not been, as far as I am aware, any detailed discussion between the
29 parties. The Authority's position at the moment is that of relatively brief cross-examination
30 of Mr. Jeffrey that should not taken very long. A few points are being picked up. Again,
31 relatively brief cross-examination of Dr. Marshall; perhaps slightly lengthier examination-
32 in-chief of Professor Armstrong.

33 THE PRESIDENT: You want to examine in chief now? Can you elaborate a little bit on that,
34 because we do not normally have much examination-in-chief in the Tribunal.

1 MISS SLOANE: There is one issue which has arisen which is the late evidence in from Dr.
2 Marshall last week. There has been a lengthy extra report in - last Thursday the Authority
3 received it. We would want an opportunity to deal with that – at least in examination-in-
4 chief with Professor Armstrong, if necessary. There is certainly no written response from
5 him for that because that extra evidence was not envisaged by any of the parties.

6 THE PRESIDENT: On the envisaged timetable, if we can just work it out a bit ---- Perhaps Mr.
7 Vajda will come in and help us a little in a moment. Was it originally envisaged that Dr.
8 Bryan and Mr. Jeffrey would take most of today.

9 MISS SLOANE: I think Mr. Vajda will be able to assist on that, given that the Authority is not
10 planning to cross-examine Dr. Bryan, and so has no idea of how long examination-in-chief
11 and cross-examination of Dr. Bryan will take.

12 THE PRESIDENT: I suppose what we had mentally envisaged was that we would start with
13 some opening statements, and we would go on with Dr. Bryan and Mr. Jeffrey. Are you
14 proposing to cross-examine Mr. Jones?

15 MR. THOMPSON: I do have some questions for Mr. Jones. Formally at least, there is the
16 witness statement from Mr. Hope. I do not know whether the Tribunal would wish to ask
17 him some questions, given that it was essentially the Tribunal's own question about
18 development of OFWAT's thinking or whether that would be an appropriate subject for
19 cross-examination as well.

20 THE PRESIDENT: I think our general view is that we are anxious that the parties should ask
21 any questions that they feel it is necessary to draw out whatever it is we want to take into
22 account, rather than ourselves, as it were, lead the questioning.

23 MR. THOMPSON: I think the largest question is clearly the approach to Dr. Bryan's evidence. I
24 had understood from the rather lengthy criticisms to which that evidence was subjected in
25 the Authority's submissions that they would wish to cross-examine, but, if not, then it
26 leaves us in a somewhat curious position, but obviously they appear to be taking that view.
27 Mr. Vajda has not yet declared his hand. Until we hear that, we do not really know what
28 the time estimate is.

29 THE PRESIDENT: Let us see what Mr. Vajda is able to tell us. How do you see it unfolding,
30 Mr. Vajda?

31 MR. VAJDA: We would propose to make an opening statement which is not going to be
32 terribly long – a maximum of half an hour. So far as the witnesses are concerned, what we
33 would be doing is cross-examining Dr. Bryan. In relation to length of time, I would have
34 thought it is going to be somewhere between half a day and three-quarters of a day. I would

1 hope less than a day. It is always difficult to tell how these things go. That is the sort of
2 best estimate I can give at the moment. We would not, at the moment, be minded to cross-
3 examine Mr. Jeffrey. Then that takes us to Mr. Jones, who is our witness of fact. Now, in
4 relation to that I would be proposing to examine him in chief. The reason for that is this –
5 and I am mindful of the observation that you, sir, have made a moment ago that it is not
6 usual: this is an extremely complex case, particularly in relation to questions of accounting;
7 how you value capital assets, and that sort of thing. In my respectful submission, what has
8 happened in other tribunals I have appeared in, it is of assistance to effectively go through a
9 few of the points in his witness statement. This is not by way of giving new evidence -----

10 THE PRESIDENT: This is going through the existing stuff.

11 MR. VAJDA: And also to ask him to comment on one or two --- because there are attacks on
12 his evidence in other documents. That exercise I would anticipate, subject to the
13 Tribunal's permission would last, say, not more than half a day. It would be by way of
14 trying to help the Tribunal understand the evidence, and also for Mr. Jones to comment on
15 one or two points in his evidence. That is as far as witnesses of fact are concerned.
16 We then come to the experts. The Tribunal will know that there has been served on
17 Friday a second report by Dr. Marshall. So far as we can see, there was no provision
18 made for reply evidence, although I can see if an application is made ----

19 THE PRESIDENT: We are not going to keep it out. Everybody has put in a lot at the last
20 minute in this case.

21 MR. VAJDA: The significant point is this, sir: in her first witness statement so far as I can see,
22 the only place where she effectively touches on ECPR and pricing is at one passage at
23 p.64. If I can just briefly take the Tribunal to that ---- The last sentence: "The ECPR –
24 that is, avoided cost – is widely recognised as a good marker for determining whether a
25 firm with market power is pricing in a predatory fashion for that is very different from ...
26 incumbent's price to be set and held at that level". Most of her report deals with ECPR
27 and regulation. That is what we have focused on in our skeleton. Now, in her most recent
28 evidence – which I can understand the Tribunal does not want to keep out – she deals, if I
29 can just ask the Tribunal to look at quite a long passage which starts at p.17, going to p.25
30 ---- It is Section F – the ECPR and Margin Squeeze. What she does there is to effectively
31 give expert evidence as to why ECPR is inappropriate in a margin squeeze case. Now, that
32 is, if you like, new evidence. It may, or may not, be inconsistent with what she has said
33 before. The more important point is that this is effectively new evidence, and we are
34 concerned as to how to deal with that. It seems to us that obviously one can deal with that

1 to some extent by cross-examination, and almost certainly we would be wishing to cross-
2 examine her on her second report.

3 There is a difficulty here as well which is that the Tribunal does not, so far as we can see,
4 have proper evidence on ECPR and margin squeeze on the other side, as it were.

5 THE PRESIDENT: I do not think it is really a question of evidence, is it? It is a question of
6 seeing what the effect of this pricing policy is on the prices that it throws up, and then
7 seeing whether that amounts to a margin squeeze that might be capable of being
8 challenged under UK or EC law. We know what the prices here throw up. We can read
9 the cases. It is a question of applying the one to the other, or seeing whether they are the
10 same, or different, or what. You strongly argue that it is different.

11 MR. VAJDA: We will abide by what the President has just said. If one looks at p.17 – just the
12 first sentence – what she says: “As noticed in my report I agree with Professor Armstrong
13 that margin squeeze is ...” and we would agree with that, it is primary, and that is why I
14 say I very much adopt the analysis that you, Sir, put to me a moment ago, but then she
15 says economic analysis can throw some light on the issue, and then effectively what we
16 have in the next eight pages or so is a considerable amount of economic analysis and as I
17 understand it the role of Dr. Marshall is that she is giving expert economic evidence, she is
18 not giving evidence of fact, and the thrust of this evidence as I understand it is to give
19 economic underpinning, as it were, for the argument that ECPR is not appropriate in a
20 margin squeeze case. Now, if the Tribunal says “We are not interested in that” then that is
21 ----

22 THE PRESIDENT: We are not saying that.

23 MR. VAJDA: No, but if the Tribunal is interested in that ----

24 THE PRESIDENT: Is not the right course for you to see what Professor Armstrong ----

25 MR. VAJDA: That is, in a sense, what I am leading up to, it may well be that the way to deal
26 with this in a pragmatic way is by a combination of cross-examination but also a
27 supplementary report by Professor Armstrong, because obviously it is important, indeed as
28 has been often observed in this case that one has not just equality of arms, but effectively
29 that both sides get the opportunity of putting in evidence on points that are of concern to the
30 Tribunal.

31 THE PRESIDENT: I would have thought the first thing to do is try to establish, if we possibly
32 can, how far Professor Armstrong disagrees with Dr. Marshall on this point. If he does
33 disagree then you might be able to bring that out – somebody might be able to bring that out
34 in chief, for example.

1 MR. VAJDA: Yes.

2 THE PRESIDENT: It may be something that Mr. Thompson or Mr. O'Reilly might want to put
3 to Professor Armstrong since they are putting their case, as it were.

4 MR. VAJDA: Precisely.

5 THE PRESIDENT: And we can then establish whether it is a real point or not.

6 MR. VAJDA: Absolutely, my key point is that this is a bit of evidence that if the Tribunal is
7 going to look at the Tribunal needs to effectively see what Professor Armstrong says about
8 it. I am very happy in a sense to accept, as it were, the way the President has put it to me in
9 dealing with that. Obviously the concern from my client's point of view is that although
10 they have come in as an intervener, and I said at the last case management conference they
11 are concerned ----

12 THE PRESIDENT: Yes, we know your client's concern.

13 MR. VAJDA: Yes, so obviously they have a concern in relation to this but I am delighted that I
14 have made myself clear on that. That really deals with our approach to the evidence of Dr.
15 Marshall. I think that is all we would have to say on evidence, subject to anything the
16 Tribunal would wish to ask me.

17 THE PRESIDENT: No, thank you. I think, Mr. Randolph, I am just assuming that you do not
18 want to cross-examine anybody and that you will make some submissions in due course, is
19 that a fair assumption?

20 MR. RANDOLPH: Absolutely.

21 THE PRESIDENT: Thank you very much. Yes, Mr. Thompson, in the light of that, are we any
22 clearer as to what is the best way of approaching this case, in particular what we can do
23 today that is useful?

24 MR. THOMPSON: If I could just take the points on the evidence? As I understand it the
25 Authority wishes to cross-examine Mr. Jeffery, and I think briefly, Dr. Marshall. I think it
26 would be worth clarifying for the purposes of this hearing what it is that the Authority
27 intends to cross-examine Mr. Jeffery about. You will recall that there are two statements by
28 Mr. Jeffery dated November 2004, which was impliedly challenged by the Authority at last
29 year's hearing. It appears to us very questionable whether the Authority should be
30 permitted now to go over that material when they could perfectly well have gone over it at
31 the last hearing, whereas the second statement, relating to comments on Mr. Hope in
32 relation to ECPR and the development of the Authority's thinking, that does seem to us to
33 be new evidence and if that is the scope of the cross-examination then so be it.

1 In relation to Mr. Jones, it does appear to us that half a day is a pretty extraordinary time
2 estimate for examination-in-chief, given that there have been three statements by Mr.
3 Jones, a 65 page skeleton argument which condescends to issues of fact from Dŵr Cymru,
4 and an opening statement from Dŵr Cymru, it does appear to us that Dŵr Cymru ought to
5 be able to make its position clear on that basis without needing to examine in chief at that
6 sort of length, but that is a matter for the Tribunal – I am not aware of any precedent for that
7 type examination-in-chief.

8 In relation to the Dr. Marshall point, obviously that is partly a matter for Mr. O'Reilly but I
9 do, with respect, question whether the characterisation that Mr. Vajda gives could possibly
10 be accepted. There is a great deal about the difficulties caused by ECPR in terms of
11 competition law in the first report of Dr. Marshall. The material that Mr. Vajda points out,
12 for example, at p.39 – “Barriers to entry and the additional entry barriers that ECPR creates”
13 – there is a lengthy section on that issue, and the passage to which Mr. Vajda appears to
14 take exception is, in fact, responding to a specific section of Professor Armstrong’s report,
15 as one can see from the repeated references to assertions made by Professor Armstrong and
16 comments by Dr. Marshall. In my submission that is a perfectly appropriate piece of reply
17 evidence, and I had thought that Mr. Vajda was objecting to the last two pages of the report,
18 which comment on Dŵr Cymru’s skeleton argument. In my submission that is a perfectly
19 appropriate form of additional evidence as well, so in my submission there is no particular
20 reason for the Tribunal to be sympathetic to Dŵr Cymru on any of the points that it makes.
21 That is our general position.

22 As far as our own position on evidence is concerned, apart from the question of a brief
23 cross-examination of Mr. Hope in addition to the, I think, hour I suggested for Mr. Jones
24 and the hour for Professor Armstrong which might conceivably be slightly longer
25 depending on how quietly he comes, as it were, that is the sort of time estimate that we
26 would still anticipate.

27 THE PRESIDENT: And what is your general view about the desirability or otherwise of starting
28 today?

29 MR. THOMPSON: Well I have sympathy with the Authority and I am not pressing to start today,
30 although it does appear to me that Mr Vajda’s time estimates are slightly worrying if we are
31 going to keep within a five day overall estimate. So if we can do something today then I am
32 perfectly happy to make my opening statement and Dr. Bryan has come here expecting to
33 be cross-examined so he could, in principle, be examined after lunch, for example.

34 THE PRESIDENT: Mr. O'Reilly, what is your position?

1 MR. O'REILLY: Relating to Dr. Marshall's evidence, Sir, we would adopt the submissions made
2 by Albion and we say it is perfectly appropriate for her to put in the statement. We also
3 thought it was the last two pages, and again those last two pages refer to comments made by
4 Dŵr Cymru in their various documents. We are hoping we can co-ordinate the questioning
5 with Albion and that therefore we are going to be very brief with Professor Armstrong. In
6 the event, clearly, that Professor Armstrong deals with additional matters it may be
7 appropriate to ask a few additional questions of Dr. Marshall by way of examination-in-
8 chief, but largely that witness will be tendered for cross-examination in the normal way. I
9 do not wish to trouble the Tribunal with any new evidence, but Dr. Marshall did indicate to
10 me shortly before we came in this morning that she had been looking through the OFWAT
11 submission where it refers to experiences internationally and in this country in relation to
12 postal services. She does have some comments to make on that and we leave it entirely up
13 to the Tribunal whether they would wish to receive an additional supplementary paper on
14 that basis. I leave it entirely up to you, Sir.

15 THE PRESIDENT: Have we actually got Dr. Marshall and Professor Armstrong here?

16 MR. O'REILLY: We have Dr. Marshall, and Professor Armstrong.

17 THE PRESIDENT: Good morning, Dr. Marshall, yes. As far as starting today is concerned?

18 MR. O'REILLY: Again, we have sympathy with the Authority. We will leave it entirely up to
19 you, but it does seem to us that in order to finish in five days then it may be useful to try and
20 get a crack at something.

21 THE PRESIDENT: Yes, thank you.

22 MR. VAJDA: I thought we had set aside six days not five days. I keep hearing five days and I
23 thought it was six days. Could I just say so far as the position of Dŵr Cymru is concerned
24 on time estimate, what we regard as being of critical importance at this Tribunal is to get the
25 facts out and I am very willing to, in a sense, do a trade, because in terms of legal
26 submissions there is a lot in writing but what is very important is that the Tribunal
27 understands the facts, and so if it means that I have to be shorter in closing submissions
28 because I take longer with Mr. Jones, so be it. But it is of critical importance, most
29 competition cases turn on the facts and it is very important in my respectful submission that
30 the Tribunal understands that and I would hope that the Tribunal will be assisted by Mr.
31 Jones's oral evidence. As I say, if that is going to then mean that I am going to be
32 squeezed, I accept that and I will then take less in closing submissions.

33 THE PRESIDENT: Thank you.

34 (The Tribunal confer)

1 THE PRESIDENT: The Tribunal's feeling is that now that everybody is here we should try and
2 do what we can today; it would be a terrible waste of cost and effort if we just did nothing.
3 What we are thinking of suggesting is that we should have the opening statements from the
4 Appellant and I think probably also from Aquavitae if there is one, so we have that on the
5 record. Dr. Bryan can then be tendered for cross-examination and we can get as far as we
6 can on that today, and we use the time today to best advantage along those lines. Given that
7 the Authority is ably represented by junior counsel and there is a transcript available, I do
8 not really see that that is an inconvenient way of proceeding, given the amount of cost that
9 has already been incurred in getting this far. So, that is what I think we would prefer to do.
10 We will proceed accordingly, if we may.

11 MR. THOMPSON: Mr. President, I should perhaps say on that point that Dr. Bryan would, of
12 course, be happy to be tendered for cross-examination again if, for some reason, the
13 Authority changes its mind about the scope of what it wants to ask questions about.

14 THE PRESIDENT: We can make arrangements as we go along.

15 MR. THOMPSON: What I was going to say by way of opening, leaving aside the question
16 about Dr. Marshall's additional report, which I think has been addressed, comes under five
17 headings: first of all, the scope of the hearing; secondly, market definition and dominance;
18 thirdly, the issue of margin squeeze; fourthly, the issue of excessive pricing; and, fifthly, the
19 ECPR, Section 66(e) issue.

20 In relation to the scope of the hearing, I think it is common ground that the hearing is now
21 focused on three questions as set out in the interim Judgment: the relative costs of potable
22 and non-potable distribution; the stand-alone costs as a cross-check on the average
23 accounting principle ---- the average accounting approach adopted by Dwr Cymru and the
24 Director, as he then was, in the decision; and the compatibility of ECPR with the Chapter 2
25 prohibition. Albion has answers to those questions. The first is that there are very marked
26 differences in costs which Dr. Bryan has done his best to identify by reference to the
27 available evidence. On the second point, this difference is confirmed by the stand-alone
28 considerations. Thirdly, at least in present market conditions, ECPR is not compatible with
29 the Chapter prohibition in relation to at least this, the dominant undertaking, and this
30 industry.

31 The first two questions are largely contained in the evidence of Dr. Bryan – or, the answers
32 that Albion gives. The answer to the third question is largely in the evidence of Dr.
33 Marshall, but also in the two statements of Mr. Jeffrey, and the submissions of Aquavitae
34 on those issues.

1 The evidence of Mr. Jeffrey is also important first of all in relation to the officious postman
2 point which still features prominently and elaborately in both Dwr Cymru and the
3 Authority's submissions. Our essential point is that the Authority, now followed by Dwr
4 Cymru, appears to ignore the client-facing aspects of this case and, as we have said in our
5 skeleton, it is notable that the wishes and perceptions of Shotton, Paper and Chorus are, I
6 think, completely absent from any submission that either Dwr Cymru or the Authority has
7 put forward in this case. It is as if there is no customer in this case. There is purely the
8 water industry that must be financed, which has a sort of self-contained life of its own,
9 indifferent to the wishes of customers.

10 Secondly, M. Jeffrey's evidence is important as to the lack of consensus on ECPR and the
11 meaning of Section 66(e) contrary to the appearance that was, I think, given in the decision,
12 and to some extent continues to be given by the submissions of the authority and Dwr
13 Cymru. So, so much in relation to the scope of the hearing.

14 Secondly, in relation to market definition and dominance, the Tribunal will recall that it
15 addressed those issues - in particular at paras. 145 and 146 of the interim Judgment. We
16 recall that we addressed those issues in some detail at paras. 25 – 41 of our 2005 skeleton
17 argument. The Tribunal will recall that the relevant standard here is that we bear the burden
18 of proof on the balance of probabilities. As we read the interim Judgment, subject to the
19 proviso that there were no final findings, there appeared to us to be findings both that our
20 market definition was correct, and that the assumption of dominance was correct – at least
21 to the balance of probabilities. So, for example, the Tribunal states that it is of the view that
22 the director was correct to assume dominance and also correct in relation to market
23 definition. These parts of the Judgment, so far as we are aware, have not been challenged
24 by either the authority or Dwr Cymru in their submissions – unlike a range of other issues
25 where they have taken quite an adverse position to the findings of the Tribunal.

26 THE PRESIDENT: Mr. Thomson, we have not really been focussing on those paragraphs in the
27 Judgment in this subsequent exchange of information. Dwr Cymru say there are points that
28 they want to make at some point, or might want to make at some point on them.

29 MR. THOMPSON: That may be the case, but we have come here on the understanding that the
30 last round was an interim Judgment and that this round would be a final Judgment. The
31 issue of dominance and market definition were before the Tribunal squarely in our
32 submissions and notice of appeal, and in the submissions we made last time. So, the
33 position needs to be resolved one way or the other. That is our position. We do say that it
34 can be resolved without any embarrassment or qualification. Really, the answer here is

1 blindingly obvious: this is obviously a paradigm case of a monopolist and there is really
2 nothing in the evidence that casts any doubt on that. The fact that contingently something
3 might happen that would change the situation is really very much the same sort of situation
4 as arose in the *Genzyme* case, for example, where there was speculation that there might be
5 other treatments in competition. There is evidence given of what that might be. But, the
6 reality was a monopolist. Here, we have a monopolist for the last fifty years.

7 Turning to the issue of margin squeeze, I take that first because in some ways it is a simpler
8 issue than the issue of excessive pricing. Again, one might compare the *Genzyme* case
9 where the President at least will recall that there is quite a high price for the drug in that
10 case, and there was an issue of transfer pricing from America, but there was no question of
11 being able to go behind and discover whether the actual price was too high, and the issue
12 simply focused on the question of the margin. Likewise here, for the purposes of margin
13 squeeze, there is no need to rule on the question of whether the overall price is excessive.
14 The issue is the creation of a sufficient margin for competition to take place. We say that it
15 is clear that a 3p margin, in broad terms, and a 3p margin conditional on having a supply of
16 water, is plainly not sufficient because it is, as the Tribunal clearly found, tantamount to a
17 zero margin in relation to retailing. We note in this respect that Dwr Cymru in the evidence
18 of Mr. Jones now appears to argue that the 3p margin was actually too great, and that the
19 true ECPR margin is now said to be 0.7p per metre cubed, which one finds at para. 91 of his
20 third statement. As I understand it, that is what he is saying – that the real, true margin that
21 should now be given is 0.7p because, in fact, the only avoidable costs relate to power. 2.3
22 of the 3p are in fact fixed costs and therefore would not be discounted on a proper ECPR
23 analysis.

24 Now, we say that that is tantamount to a predatory price at the upstream level, and a zero
25 margin at the downstream level, and that the overall effect would be to make any market
26 entry obviously impossible.

27 Again, we address the issue cautiously because of the general terms of the interim
28 Judgment, but it does appear to us that the Tribunal has already indicated that it is inclined
29 to accept Albion's case as a matter of principle. In particular, we note the terms of paras.
30 395 – 396 of the interim Judgment which appears to us to suggest that the ECPR approach
31 does not do justice to the Chapter 2 prohibition and is inconsistent with the statements made
32 by the Commission and by the Court of Justice in relation to that issue.

33 We say that further evidence now confirms our case. In particular, we note the issue of
34 avoidable retail costs where the decision appears to completely duck the issue, and simply

1 addresses the question of the water flowing through the pipes, and does not look at the
2 customer facing costs at all. Likewise, both Professor Armstrong's report and the decision
3 – and, indeed, the submissions of both Dwr Cymru and the Authority – appear to overlook
4 the issue of fixed costs, and seek to equate the ECPR and margin squeeze by simply
5 ignoring the issue of fixed costs.

6 Thirdly, and eloquently stated in the report of Dr. Marshall, there is the issue of barriers to
7 entry and the extent to which the approach of the Authority ignores the facts that there are in
8 fact very substantial barriers to entry in this industry and that a pure ECPR approach
9 completely overlooks the effects of those barriers to entry, and, indeed, aggravates the
10 difficulties facing a market entrant to this market. So, we say that the margin squeeze case
11 certainly should succeed on any view.

12 My fourth point – excessive prices. We accept, as the Tribunal said at para. 270 of the
13 interim Judgment, that the question of excessive pricing is not an exact science, and that
14 there is inevitably a degree of uncertainty deriving from the various different routes that you
15 can take to this question. However, we say we have a very strong case here and we note, in
16 particular, the agreed very low costs of raw water distribution at apparently 2p per metre
17 cubed, expressed as a regional average, which is, as I understand it, the relevant approach
18 adopted by the Director and Dwr Cymru. The very close analogy between raw water
19 distribution and non-potable distribution, as now emerges from the detailed evidence and, in
20 particular, the maps comparing the two activities. Thirdly, the levels of regulation,
21 investment and complexity of the distribution systems for potable water, including bulk
22 potable water. Fourthly, the stand-alone analysis when based on appropriate assumptions as
23 to the capital values of the Ashgrove system and the rate of return for an incumbent
24 monopolist such as Dwr Cymru.

25 In this respect we refer, of course, to Dr. Bryan's evidence. We note also that the third
26 statement of Mr. Jones apparently asserts – and indeed it is implicit, I think, in his earlier
27 evidence – that the price that we are considering is actually too low. One finds that
28 specifically at para. 13 of his third statement where he appears to imply that the discount of
29 the treatment costs – you will recall, down to 15 percent of the potable treatment costs –
30 may have been based on an inappropriate comparison, and that in fact the price would
31 actually go higher. Some of the comments about the risk of stranding in relation to non-
32 potable assets and the ability to spread costs across a wider customer base appear to us to
33 imply that there is a higher level of risk in relation to non-potable than potable, and that, if

1 anything, the price of non-potable distribution is too low. That again we find a striking
2 aspect of the Dwr Cymru evidence.

3 My fifth topic – ECPR and the costs principle. Our basic submission on ECPR is that it
4 does not assist the Tribunal, either in relation to margin squeeze or excessive pricing
5 because it cannot override or change the purport of the legal issues that arise on those two
6 headings. In relation to margin squeeze, it addresses the wrong issue – the avoidable costs
7 of the incumbent; not the total costs of the incumbent or the reasonably efficient competitor
8 on the downstream market. It requires information in relation to avoidable costs on both
9 resources and retail markets that is not readily available, and was not available to the
10 Director in this case. It gives the incumbent every incentive to hide avoidable costs and
11 treat them as part of its either fixed costs or upstream network costs, and the facts of this
12 case in relation to the retail market are a striking illustration of that risk manifested in its
13 most blatant form. It raises barriers to entry by the need for case by case negotiation,
14 variations from time to time as the retail price of the incumbent changes and delays caused
15 by the need to negotiate the initial price on an individualised basis and then from time to
16 time. These issues are very eloquently set out in the report of Dr. Marshall. Moreover, it
17 equates to predation on both the up and down stream markets if there is any under
18 accounting of avoidable costs applying the conventional *Axo* case because it effectively
19 creates a presumptive form of predation on both the upstream and down stream market if
20 there is any under accounting. In our submission para.91 of Mr. Jones’s third statement
21 illustrates that risk again in operation whereby a common carriage price whereby Albion
22 both buys the water and retails the water is expected to be carried on at 0.7p m³ in
23 competition with Dŵr Cymru.

24 In relation to excessive pricing we have said at various points, and we maintain that ECPR
25 is nothing to the point, because it accepts precisely what it purports to prove, namely, that
26 the price upstream is reasonable, and casts no light whatsoever on whether or not it is
27 reasonable, so it is an entirely useless cross-check, and given that that was the sole use to
28 which it was put in the Decision then that is, itself a damning indictment of the Decision
29 which means that it must be set aside.

30 In relation to the costs’ principle, we say that it means what it says. It is concerned with
31 costs. It is much more natural to take it as a principle for ensuring that the incumbent
32 recovers first of all the local or actual costs of the service, plus a proportionate contribution
33 to fixed and common costs including, where appropriate, any costs of universal service
34 provision. We note in that respect that para.357 of the interim Judgment appears to confirm

1 that that is an approach which has been used in other industries and would apparently work
2 perfectly well here, and would be entirely compatible with the wording of the legislation.

3 We say that Dr. Marshall is an excellent, perhaps a pre-eminent position to comment on
4 this issue and so we think that the Tribunal is likely to be assisted in this respect as in a
5 number of others by her evidence. That is what I wanted to say by way of opening, and Dr.
6 Bryan and Mr. Jeffery are here if there is going to be cross-examination, though I
7 understand Mr. Jeffery is only to be cross-examined by the Authority so it may well be that
8 it will be delayed until tomorrow.

9 THE PRESIDENT: We may have to defer that until tomorrow. I think the most convenient
10 course then, Mr. Thompson, if you would just ask your client to come into the witness box
11 over **here**.

12 MR. THOMPSON: I do not know whether there are any more opening statements the Tribunal
13 wishes to hear before?

14 THE PRESIDENT: Of course, yes, and I think Mr. O'Reilly probably wants to follow before we
15 do that, yes.

16 MR. O'REILLY: Thank you, Sir. We naturally adopt those submissions as our own. Perhaps I
17 should just say something about the scope?

18 THE PRESIDENT: Yes.

19 MR. O'REILLY: The interim Judgment in para.8 refers to a relatively short final stage ----

20 THE PRESIDENT: I know. It was a bit optimistic, was it not?

21 MR. O'REILLY: Yes, well we hope that this is the final stage and perhaps I could just make that
22 plea on behalf of my clients. Some of the submissions that have come in recently have
23 alluded to the prospect that water might be different; water supply and water networks
24 might be intrinsically different to other network industries. We reject that suggestion
25 entirely, although of course water is wet and other products are not that does not necessarily
26 have any impact on the way they are delivered intrinsically and we suggest that all the
27 lessons learned from other network industries, and the liberalisation of those industries are
28 apt to be transferred to water. Indeed, if there is anything to be said about it is that other
29 materials do not failsafe like water does. For example, in water you can lose 40 per cent. of
30 it in your pipeline and nobody gets hurt, and that is something that cannot be said, for
31 example, for gas or electricity.

32 The comments that we propose to make now relate solely to the scope of our intervention
33 which is a very limited one. The reason we intervened, as made clear in our notice of
34 intervention originally, was because we took issue with the Director (as it was at the time)

1 his interpretation of s.66(e), his equation of it with an ECPR principle and his use of it as a
2 cross-check. Although the interim Judgment simply alludes to these questions we do invite
3 the Tribunal to look at our previous submissions, right back to the intervention statement,
4 the skeleton in the main case, and the submissions that have been made more recently.
5 The question of ECPR is, of course, a legal one, but I would like to say a few words about
6 the evidence that is being given and may be given. The ECPR seems to reset upon an
7 economic principle that would see new entrants not only being required to perform
8 efficiently in the sense that that term would be used in normal everyday parlance, but super
9 efficiently because it focuses only on the margin and, as Mr. Thompson says, it does not pay
10 any regard to the fixed costs, and that really is a problem. It means that the margin will
11 never be adequate except in exceptional cases and the intrinsic analysis of ECPR is such
12 that margin squeezes are very, very possible indeed, and with it implications arise. To
13 legislate so that ECPR becomes the rule will be effectively Parliament requiring parties in
14 certain circumstances to breach the Chapter II prohibition. We say that cannot be right. So
15 we say there is a major issue there about margin squeeze, there is a major issue about
16 barriers to entry, and, of course the application of an ECPR principle requires information
17 which is not readily available and, as Mr. Thompson says, this case shows exactly how a
18 dominant undertaker can hide their costs, either upstream or as part of the fixed costs.
19 In relation to the interpretation of the costs' principle we refer the Tribunal to the
20 submissions we made earlier, last May, when we handed in a document which looked at
21 each of the three streams, as it were of competition.

22 THE PRESIDENT: We have reminded ourselves of those, Mr. O'Reilly.

23 MR. O'REILLY: We may invite the Tribunal a little later to have a look at some of the guidance
24 that has emerged since then. OFWAT and now the Authority, have published guidance on
25 the application of those principles, which show a very slim margin indeed, using their
26 worked examples, and it may be appropriate for the Tribunal to have a look at that and to
27 ask itself whether or not those figures could ever survive a margin squeeze challenge.
28 Finally, just to make a comment about the Competition Act 1998, there were some
29 suggestions in the Decision that the cost principle overrode the Competition Act 1998 and,
30 of course, if it was necessary that there be an infringement of the Chapter II prohibition in
31 order to make s.66(e) work, then we would have to accept that. But of course we say that
32 the true interpretation of s.66(e) is such that it is entirely consistent with the Competition
33 Act. Moreover, if Parliament had wished to override the Competition Act it would have
34 said so expressly and the reliance placed by the Authority, and others, on Parliamentary

1 debates we say, is entirely misplaced. Mr. Elliott Morley does use the expression “retail
2 bias” at one place, but he also says in other places that the costs’ principle is just that. We
3 say that the costs’ principle, being named the “costs’ principle, one should start off with the
4 assumption that it has something to do with costs. It could easily be named the “retail
5 minus” principle, but it was not. Indeed, when one has a look at the Parliamentary debates
6 one sees that Parliament, and Mr. Elliot Morley in particular, who is the promoting
7 Minister, took the view that this should be a pilot study for three years and that in the event
8 for large users (15 megalitre users) it proved successful then it would be extended.
9 Certainly, the approach which we say that OFWAT and now the Authority are adopting has
10 tended to stifle entry into that market rather than to promote it and will not see the
11 parliamentary aims being met.

12 Thank you, Sir.

13 THE PRESIDENT: Thank you very much. I think Professor Pickering has a question?

14 PROFESSOR PICKERING: Mr. O’Reilly, you refer to the worked example provided by the
15 Regulator. I wondered whether you had any comments or thoughts as to whether the fact
16 that such a worked example, and pointing in your view to a particular interpretation, is
17 appropriate for a Regulator seeking to promote competition?

18 MR. O'REILLY: In our submission it is entirely inappropriate for a Regulator to try and stifle
19 competition. In our submission the only way one can view that worked example, and the
20 figures that emerge are £397 of a margin on an overall turnover of something like £300,000-
21 odd – approximately a 0.1 per cent. margin. In our submission that is entirely
22 inappropriate, cannot survive a Chapter II test and in our submission also the equation being
23 used by OFWAT, which is a retail minus, plus the expenses incurred by a monopoly is
24 inappropriate, and perhaps we will hear from Professor Armstrong and Dr. Marshall as to
25 whether they would agree with that proposition. But, in our submission the entire document
26 is designed to ensure that competition does not raise, rather than that it does arise.

27 THE PRESIDENT: I think, Mr. O’Reilly, if I may make one cautionary comment, we are at this
28 stage – indeed at all stages – deciding no more than the validity of the Decision under
29 Appeal. We are not looking more widely into the effect of the way it is envisaged that
30 s.66(e) works in practice, and taking a view on the legality or otherwise of that. However,
31 subject to argument, we can probably look by way of background at some of these
32 examples, with the view to familiarising ourselves as to how this principle relied on in the
33 Decision is expected to work in practice. But I do not think any more than that, probably.

34 MR. O'REILLY: If it may assist, I do not know whether the Tribunal has copies of the Guidance.

1 THE PRESIDENT: I am sure we do, yes.

2 MR. O'REILLY: It may be appropriate to ask, perhaps, Professor ----

3 THE PRESIDENT: If you make sure through the Registry that we have available to us any
4 document that you want to take us to in due course.

5 MR. O'REILLY: Yes, thank you.

6 THE PRESIDENT: Very well. I am rather assuming, we would have the two opening statements
7 of the Authority and the Intervener together, but you may want to proceed ----

8 MR. VAJDA: Well I had planned an opening statement, if the Tribunal would like to hear it?

9 THE PRESIDENT: If you are ready to give it then we are delighted to listen to it.

10 MR. VAJDA: The Authority does not have an objection to me giving an opening statement.

11 THE PRESIDENT: Fine.

12 MR. VAJDA: There are two live issues that arise out of the notice of Appeal which are still live.
13 First, was the access price of 23p excessive; and secondly, did it involve a price or margin
14 squeeze?

15 At the last hearing the Tribunal had very little evidence before it, essentially most of – I call
16 it evidence – was contained by assertion one way or another in the pleadings and plainly the
17 Tribunal felt – probably correctly, if I may respectfully say – that on a number of points
18 more evidence was needed and that is why the Tribunal decided in an Interim Judgment that
19 the Interim Judgment decided nothing. Again, with respect, a perfectly understandable
20 approach. Now, we come here today, Sir, with a considerable amount of further evidence,
21 and the question that I would just like to address briefly is: what is the Tribunal to make of
22 this new evidence?

23 Let us start by looking at excessive prices. The challenge here, leaving ECPR to one side is
24 a challenge on the facts. The challenge that was made in the Notice of Appeal and, indeed,
25 in the various methodologies subsequently adopted was that the authority had made errors
26 of a quite catastrophic nature. We are not talking about small numbers here. You will
27 recall, Sir, that the Authority on the whole company average cost approach had reached the
28 conclusion that the access price was 19.2 pence per m³?

29 THE PRESIDENT: Yes.

30 MR. VAJDA: You will also recall that the Authority did not conclude that the access price of
31 23.2p per metre was excessive on the basis of the United brands test. The attack on the
32 Authority is not, as I understand it, that the Authority has mis-applied the United brands, i.e.
33 in error of law, but that the Authority's figure of 19.2p per metre was, if I can put it like
34 this, completely off the radar.

1 Now, to see how far off the radar this goes, I would just like to focus on the six
2 methodologies that were looked at previously. By my understanding – and I have based
3 myself to some extent on the very helpful skeleton of the Authority – the range that was
4 given by Albion in those six methodologies was between 1.3p per cubic metre and 4.59p per
5 cubic metre. In other words, the Authority’s calculations were between 1400 and 400
6 percent too high. Those are huge differences.

7 So, effectively, it is of course possible - and I am not acting for the Authority – that the
8 Authority lost the plot completely. But, what we say – and we are confident that this court
9 will examine very carefully to see whether the evidence that the Authority lost the plot in
10 that way is cogent, compelling and irresistible.

11 Now, since the first hearing, sir, further figures have been produced. If I can just give you
12 those again in a nutshell: the current range, so far as treatment costs are concerned, is (and I
13 am simplifying) between 1.6 and 2.4p per cubic metre, and that compares with a figure in
14 the decision of 3.2p per metre. So far as the distribution costs are concerned, the range now
15 is between 1.4 and 2p per cubic metre. That compares to, as the Tribunal will recall, a figure
16 of 16p per cubic metre in the decision. So, that is an eight-fold difference.

17 Now, one of the things that the Tribunal asked the parties to do was to try and get a price on
18 a stand-alone basis. No doubt the Tribunal was trying to sort of grapple towards some form
19 of common ground here. Again, there has been a huge discrepancy in relation to what I can
20 put as the stand-alone cost.

21 THE PRESIDENT: There seems to have been some confusion about this expression ‘stand-
22 alone’ which seems to be used in two senses. But, I think what the Tribunal was trying to
23 get at was the cost of running the Ashgrove system – not the cost of rebuilding a new
24 system and starting from that.

25 MR. VAJDA: The cost of rebuilding the system is what is really meant by the OFT test of a
26 stand-alone system.

27 THE PRESIDENT: That is a debate which we will not go into in opening statements.

28 Nevertheless, it was not what we wanted. What we wanted was what it has actually cost to
29 run this thing.

30 MR. VAJDA: Just for opening purposes, sir, the Albion stand-alone figure has a treatment cost
31 of 1.622p per cubic metre and a distribution cost of 1.1571p per cubic metre, which, on my
32 arithmetic, reaches an aggregate of 3.193p per cubic metre. So, that is what the Albion
33 stand-alone figure is. That compares with the Authority’s stand-alone cost of 25p per cubic

1 metre (that is at Annex 3 to their skeleton), and Dwr Cymru's stand-alone cost of 32.4p per
2 cubic metre.

3 What the Tribunal will have to grapple with is: why is there is such a huge difference in
4 those figures – a difference of over eight-fold? In relation to stand-alone costs, which I will
5 come back to in a moment, the main reason that there is such an enormous gap is because of
6 the capital value and the cost of capital. I will come back to that in a moment. Can I just
7 focus for the moment on the differences so far as the whole company average basis is
8 concerned? Again, we have seen that effectively what is said is that the Authority went off
9 the radar; they lost the plot. These are the sort of factors that we say the Tribunal might find
10 it useful to focus on.

11 So far as treatment is concerned, one of the factors is: do the Albion figures properly take
12 account of capital costs? I say no more on treatment for the moment.

13 So far as distribution is concerned, that of course, as the Tribunal quite rightly recognised at
14 the last hearing, is the area where there is the biggest difference, and there is even the
15 biggest difference – basically an eight-fold difference. So, there are two questions that I
16 would submit the Tribunal needs to ask themselves: (1) are there in fact differences in the
17 cost of distribution of non-potable and potable water? (2) If so, are those differences of
18 such a magnitude as put forward by Albion?

19 I just want to spend a brief moment looking at the relevant factors. In Albion's notice of
20 appeal, in order to substantiate its case on the differences point, they relied on the integrity
21 of the pipes. That was one of the points in the notice of appeal. They also relied on what I
22 call the location factor – that is to say, they said, “Well, actually, when you look at this,
23 non-potable basically in rural areas; potable in -----“ Again, this is something the Tribunal
24 will have to focus on. Then, they also focussed on length of network, which is that
25 effectively the potable mains were twice as long as non-potable and raw.

26 Since that hearing they have put forward – and I will come to this in a moment, because I
27 dread to use the expression in this Tribunal, but there is a sort of pleading issue here – or
28 developed ---- They have put, we would say, a new case which is effectively
29 Methodologies 7 and 8. This is all going, sir, to the critical question: what is the difference?
30 Methodology 7 – and we heard that being flourished by Mr. Thompson this morning - is
31 that actually the real comparator is non-potable and raw, and they are pretty much the same
32 because raw water distribution is 2p per cubic metre. That is what non-potable is.

33 The next new case – which I call Methodology 8 – is what I call the complexity of the
34 pipes. That is, if you like, a new point. I am going to say no more about that because those

1 are matters that will be explored in evidence. I will come back to Methodologies 7 and 8
2 when I deal with the pleadings in a moment.

3 Moving on to stand-alone, sir, it is common ground that the major component of doing the
4 stand-alone calculation is the capital element. That is, of course, not surprising given that
5 this is a very capital intensive industry, and, as we all know, the largest item of our water
6 bill is effectively the capital cost. There are two major areas of disagreement between
7 Albion and the Authority and Dwr Cymru. These, again, with respect, are matters, we say,
8 that would be of assistance for the Tribunal to focus on. Issue 1: what is the capital value
9 to be attributed to the two items --- the two assets in the Ashgrove system? The Tribunal
10 will recall, we have got, effectively, above ground the treatment plant, and then we have got
11 below ground the pipes. That is, if you like, the first issue. There is a big issue of debate on
12 that. The second issue – which, in a sense, magnifies the first issue as well – is: what rate
13 of return should be used for raising that sum of money? Those are really the key issues on
14 the stand-alone costs. We would say the Tribunal would do well to focus on those.

15 THE PRESIDENT: We are entirely with you, Mr. Vadja, that there are some disputes about cost
16 elements. But, those are the critical points.

17 MR. VAJDA: Those are the critical ones. Yes, absolutely. Now, what I would like to do is to
18 make three brief observations about stand-alone costs – the stand-alone basis. First, the
19 Authority has made a powerful case as to why stand-alone is inappropriate in the water
20 industry. I think for the purpose of opening, I will simply say that we adopt that. I will
21 develop that. We do say that it is very important to remember – and perhaps I could just
22 ask the Tribunal to make a note of this – the point we make at paras. 112 and 113 of our
23 skeleton. These are also points the Authority makes at paras. 49 and 50 of its skeleton, and
24 the third bullet point at para. 56. One is looking at how one slices up the cake here, because
25 although we are, of course, dealing with large users who do not have price control in the
26 same way that domestic customers do. They all come within the basket. What happens is
27 that all the water undertakers are given a fixed amount of revenue that they can earn. They
28 can earn it from the price cap customers – domestic customers. They are effectively
29 capped. Then there are, if you like, the uncapped customers; the large customers. So far as
30 the uncapped customers are concerned, they do not have the protection, as it were, of price
31 capping. They have Condition E.

32 THE PRESIDENT: You say ‘all within the basket’. I had rather assumed that quite a lot of this
33 was out ---

1 MR. VAJDA: No. No. Not in the basket, but effectively there is a certain amount of money
2 that the water undertaking can earn and the price regulation is based on that. So, effectively,
3 the point I am making is that if the water undertaking earns less from, if you like, the non-
4 price capped people than anticipated, that is going to have a knock-on effect in future on the
5 price-capped people because one is looking ---- This is why one looks at the whole
6 company basis, and one does not look at it on a customer-by-customer basis.
7 So, we will be inviting the Tribunal to re-visit, if I can put it like that, para. 328 of its
8 interim Judgment, but I do not want to develop that point any further at the moment.

9 THE PRESIDENT: I think we might need to be sure that everybody has understood how this
10 pricing regulatory system works.

11 MR. VAJDA: Yes. I think I will move on to the second point on stand-alone, which is this: that
12 one of the Tribunal's concerns about the whole company approach was the long chain of
13 allocation (I quote from para. 317 of the interim Judgment). It wanted to have a cross-
14 check. Now, if one is going to use a stand-alone cross-check in the water industry and
15 applies the OFT test, which is laid down in the various guidelines, one has to then ask the
16 question: what is the least cost that would be incurred by a hypothetical, efficient
17 undertaking supplying only that product.

18 Now, that will inevitably require the largest element of the stand-alone cost to be estimated
19 – namely, the capital element. That is simply, sir, because water undertakings – such as my
20 clients - do not run their businesses or maintain their accounts in a way in which one would
21 be able to see, at a glance, the replacement cost of a specific asset. This was explained –
22 and perhaps all I need do is just give the Tribunal a reference – in a letter written by my
23 instructing solicitors to the Tribunal on 20 March. Probably the convenient place to find it
24 for the Tribunal is at CAJ1 to Jones 3. The basic point here is that a water undertaking is
25 subject to a number of specific statutory, and other, obligations, and does not run its
26 business in the way that, for example, Tesco runs its business. A company like Tesco will
27 have hundreds of profit centres and cost allocation. So, for example, and this is what
28 management does, and this is no doubt why the company is so successful, you can identify,
29 say, the profitability of a fish counter in a specific supermarket and say “Are we going to
30 earn more on our capital by replacing the fish counter, say, with a bread counter?” That is a
31 very useful, and no doubt frequent exercise that is undertaken. Of course, that is done
32 because Tesco can decide to switch around if it wishes to do. So far as a water undertaking,
33 if one just takes Ashgrove for example, Dŵr Cymru is not in a position simply to say “We
34 would like to close Ashgrove down because it is not making quite as much money as we

1 like”. So that is an important point because it shows that we are looking at an industry
2 where things are done differently from one which is unregulated.

3 What a water undertaking is concerned to do, Sir, is first of all obviously to ensure that its
4 assets are being operated efficiently. That is to say, that it keeps a tight rein on the
5 operating costs of those assets, and it therefore has records of those operating costs that its
6 management can control, and it can hold its management accountable for those operating
7 costs.

8 It also plainly has regard to what I might call “network efficiency”, that is to say the lowest
9 cost investment where it is necessary to replace, upgrade, or expand part of the network.
10 The way that that is done, and again I am sure the Tribunal is familiar with this, is that the
11 information is presented by the water undertaking to OFWAT every five years, and that
12 information is then evaluated by a reporter, and by the Authority itself.

13 Insofar as one then looks at specific capital projects, what a water undertaking would do,
14 such as Dŵr Cymru is it would then have a look at a strategic plan to see what needs to be
15 done, but it would only actually calculate the detailed numbers when the capital investment
16 is actually contemplated. In the case of Dŵr Cymru, when the capital investment is actually
17 undertaken, the way that it proceeds is through subcontracting – that is a sort competitive
18 tendering process. That is the second element of efficiency.

19 The third element, and this again is very important when one is looking at stand-alone costs
20 Sir, is what I would call “capital efficiency”, because given that the cost of capital accounts
21 for something like a third of everybody’s water bill, it is of critical importance that the
22 investment is financed as efficiently as possible, because of course any divergence there can
23 have a large impact on the bill. So that completes the second point about a stand-alone. It
24 is simply to say that, yes, stand-alone does have quite a lot of estimated cost. There is no
25 sort of Machiavellian reason for that, it is simply because of the way that this industry
26 works.

27 I now come, Sir, to the third and last point on stand-alone. The calculations have now been
28 done. What we say, and indeed very much adopt what the President said to Mr. O’Reilly a
29 moment ago, the scope of this hearing is obviously to see whether the Decision stands, and
30 we say that the Tribunal should only use the stand-alone figures as a cross check to see
31 whether or not the Director, or the Authority as it is now called, was correct in his
32 conclusion on the access price. I say this, you will have seen, for example, that there is a
33 different figure produced by Dŵr Cymru and the Authority. You will also have noticed that

1 the Authority – I am not criticising the Authority – produced its figures for the first time in
2 its skeleton.

3 THE PRESIDENT: Yes.

4 MR. VAJDA: The Authority rather grandly says “We do not accept either Albion or Dŵr Cymru,
5 we have come up with a different figure”, they are perfectly entitled to do that. Obviously,
6 if there is going to be a debate which has never yet happened as it were between the
7 Authority and us as to what the stand-alone cost is, we would wish to come back on a
8 number of the points the Authority makes. The important point, we say, here is whether
9 you take the Authority’s approach, or Dŵr Cymru’s approach they effectively support the
10 access price and, obviously, the critical question that the Tribunal has to ask here is “Were
11 the Authority and Dŵr Cymru in the right ball park in relation to costs to the capital value
12 and the cost of the capital? That is all I wish to say on excessive pricing. I have two final
13 points which I shall be very, very brief on.

14 First, ECPR margin squeeze. Essentially, we would say that there are two issues here. Is
15 there a separate and identifiable downstream market in the sense that something is being
16 done by – if I can put it like this – the competing undertaking at the downstream level that
17 avoids the dominant undertaking having to do it? That, we say, is essentially a fact specific
18 question in relation to this case.

19 The second issue is, in the light of , if you like, the factual answer to question 1: “What is
20 the correct legal approach to apply?” As we say – I am not going to develop this further –
21 the *Deutsche Telekom* case, for example, which the Tribunal referred to last time round we
22 say is in a sense factually distinguishable from the present case.

23 THE PRESIDENT: Yes.

24 MR. VAJDA: I come, Sir, to the last point and it is a pleading point. I am going to be quite short,
25 but can I say this: In the Notice of Appeal three methodologies were put forward. One of
26 those, I understand, the third party service has been abandoned. Three new methodologies
27 were put forward and considered in the interim Judgment as it were between the Notice of
28 Appeal and the interim Judgment. We would submit that it would be appropriate in the
29 light of the Tribunal’s own Rules, which talk about needing leave to amend the Notice of
30 Appeal that the pleadings are brought into order in relation at least to any methodology from
31 4 to 6 that is still being relied on.

32 So far as the two new methodologies are concerned, which I have referred to
33 (methodologies 7 and 8) can I just spend a moment – I am not in a sense saying “Well Mr.
34 Thompson should be shut out”, but what I am saying is that it is important for this case to be

1 in apple pie order. It is important, if this case goes further, the Court of Appeal can say
2 “Where is the pleading? What has been pleaded? We know where we stand.”

3 THE PRESIDENT: Yes.

4 MR. VAJDA: Methodology 7 is the point that the relative costs of distribution for potable and
5 non-potable water are the same – raw water. In relation to this, this is, with respect, a new
6 point. As I say, I am not coming here to shut Mr. Thompson out, but it is important that the
7 Tribunal appreciate that this is a new point and, indeed, if I could just ask the Tribunal to
8 look very briefly at Dr. Bryan’s fourth witness statement at para.24. What Dr. Bryan says
9 here is that neither Dŵr Cymru nor the Director has considered the possibility that the
10 characteristics of non-potable distribution could be more closely related to raw water
11 distribution. That is entirely true, that is because this point has never really been raised until
12 now.

13 THE PRESIDENT: Well it has been around, Mr. Vajda, not quite like this but the whole question
14 of these things not making a distinction in the classification between raw water and non-
15 potable, and so forth and so on. We have heard quite a lot about raw water and the
16 difference in qualities and all the rest of it.

17 MR. VAJDA: With respect, one cannot plead cases by “well it has been around”. In my
18 submission this needs to be pleaded, and the important point here, Sir, is that methodology 7
19 is different from methodology 2. Methodology 2, you will recall, proceeded on the basis
20 that the Ashgrove system itself was a raw water system, and what was said was that the
21 waste treatment plant was basically no different from a reservoir. So that was a point,
22 methodology 2 was specific to Ashgrove.

23 THE PRESIDENT: Yes.

24 MR. VAJDA: What is said here, now, is not that the Ashgrove system is a raw water system, but
25 methodology 7 proceeds on the basis that Ashgrove is a non-potable system, but what is
26 said is that if you now compare non-potable systems generally across the board two raw
27 water systems generally effectively there is no difference between the two.

28 THE PRESIDENT: Yes.

29 MR. VAJDA: So that is a different point and, if we get to the Court of Appeal, we need to know
30 where we are, and it has not been pleaded. As I say, I am not saying it should not be, but I
31 am saying is that there needs to be a proper amendment, and there needs also, with respect,
32 an explanation as to why this point is being taken now.

33 Methodology 8, Sir. I have mentioned this already. It is now being said that the main
34 difference between non-potable and potable is the conjunctive network point. You will

1 recall that I said that this was a point that was not raised in the Notice of Appeal at all. It
2 has been raised for the first time in response to Mr. Jones's third witness statement. It is
3 now at the forefront, well it is para.20, if we just look at the skeleton for this hearing.

4 Perhaps it is easier if I just read it, it is a short passage – it is really the second sentence:

5 “In summary potable bulk distribution is a highly regulated and complex service
6 involving an integrated conjunctive network of pipes serving very large numbers
7 of consumers over wide areas...” etc.

8 I have searched in vain, but that is simply not in the Notice of Appeal, because, as I say, in
9 the Notice of Appeal we did not identify that factor. In my respectful submission it is not
10 sufficient to say “Well, it is basically in the case”, it needs to be pleaded, and there needs to
11 be an explanation as to why it has been pleaded.”

12 Subject to that, Sir, that is all I have to say at this stage.

13 THE PRESIDENT: Thank you very much. Mr. Randolph, I do not think you are going to avail
14 yourself of an opening statement, is that right?

15 MR. RANDOLPH: I was not planning to, Sir, unless you have particular comments? You recall
16 at the last hearing you had particular comments to raise with my client.

17 THE PRESIDENT: No, we will come to it in due course.

18 MR. RANDOLPH: I was going to assume that it would be more helpful to wrap up all my
19 comments in one at the end, so I can take in any evidence and indeed deal with any
20 particular points. But, Sir, I would say this, if the Tribunal has any particular questions
21 arising out of my submissions in writing, specifically with regard to the question posed to
22 me and my client with regard to our keenness or otherwise, with regard to competition, then
23 it might be of assistance to have those further questions before I stand to make my final
24 submissions. But if the Tribunal is content ----

25 THE PRESIDENT: We will see how we get on, Mr. Randolph.

26 MR. THOMPSON: Sir, I do not know how far the Tribunal wants to hear from me about the
27 pleadings.

28 THE PRESIDENT: Well I think we ought to try to bottom-out the pleading point. Mr. Vajda is
29 very properly not saying “We are going to exclude these points”, and that is an entirely
30 proper and responsible approach on his part, but he is saying that we need to have it framed
31 in a way that is recognisably pleaded, so that we know exactly what the grounds set out in
32 the Notice of Appeal are.

33 MR. THOMPSON: I think the short answer is that the raw water issue was, I think, specifically
34 identified by the Tribunal in three subparagraphs of para.302, and so the comparison

1 between raw water and non-potable arose from that, and the more one looks at it the more
2 striking it is as a comparison. But whether it needs to be pleaded in addition to the point
3 that Mr. Vajda properly put to you, namely the comparison that was always there between
4 Ashgrove and raw water, if that is necessary then that could be obviously done.

5 The second point, on the conjunctive network, I think it is a curious point for Mr. Vajda to
6 take because the issue arises from the evidence of Mr. Jones, paras.37 and 38, where he
7 notes that potable distribution largely takes place by reference to conjunctive networks in
8 the Swansea and Cardiff area, and in relation to the other two (or maybe three) which are
9 not within those two areas there is also an element of conjunctive network, and so that is a
10 point that in response to the Tribunal's question Mr. Jones raised. So I am not sure what
11 objection is taken to our relying on that evidence.

12 THE PRESIDENT: Well I think we just have to come back at some point, but I do not suggest
13 we do it now, to the rather technical matter of whether we should have two or three
14 paragraphs as pleading that can be treated as the part of the Notice of Appeal so that we
15 know what the point is. That is not a point that I wish particularly to rule on at the moment
16 because we want to get on with the case.

17 MR. THOMPSON: I am grateful. Obviously, if it is required that we say that we rely on the
18 evidence of Dr. Bryan we can clearly say that.

19 THE PRESIDENT: Could I just say one other thing, and this is more a general comment to bear
20 in mind when we get to the expert evidence, or expert input. We are particularly interested
21 in making sure that we understand in what sense this word "efficiency" or "efficient" is
22 being used at various stages in the argument. We have references among other things to
23 static efficiency, to productive efficiency, to dynamic efficiency, to an efficient firm, to
24 efficient prices, and we may need just to be sure at various stages that we all know exactly
25 what we are talking about and we are not confusing each other by using this rather
26 imprecise word sometimes in different senses. Professor Pickering rightly reminds me, as
27 he did just before we started, "efficient" used in the sense of "efficient" entry, just so that
28 we are all clear what it is we are talking about, and if we are slightly at cross purposes we
29 need to understand that. I do not think we are at cross purposes and I have a feeling we are
30 more or less on top of it but I want to make sure that we are on top of it and we have not
31 misunderstood anything.

32 MR. THOMPSON: I am grateful. I am sure that is very helpful and, as I understand it, the
33 experts are in court and will no doubt bear it in mind.

34 THE PRESIDENT: Is it convenient to go on now or would the parties like a five minute break?

1 MR. THOMPSON: Dr. Bryan would not mind a five minute break, I do not know whether
2 anybody else would.

3 THE PRESIDENT: Mr. Thompson, I am envisaging you will put Dr. Bryan into the witness
4 box, establish who he is, draw his attention to the three witness statements that he has
5 produced, and then we go over to Mr. Vadja to ask his questions.

6
7 (A short break)

8
9 DR. JEREMY ROBERT BRYAN, called

10 Examined by Mr. Thompson

11 Q Dr. Bryan, can you give your full name, and your role within the Applicant, and your
12 address, please? A. My name is Dr. Jeremy Robert Bryan. I am the Managing Director
13 of Albion Water. The current office address is 71 Clarence Road, Teddington, Middlesex.

14 Q I believe that you have sworn four statements in these proceedings. If I could just show you
15 three of them ---- The fourth, I think, is in relation to interim measures and I do not think is
16 relevant to anything today. However, in relation to the three, first of all do you have the
17 notice of application bundle, Bundle 2? If you turn to Tab 6, there is a statement which has
18 your name on it, and at the back there is a signature and a date of, I think, 28 July, 2004.
19 Can you confirm that that is your statement, and that that is your signature? A. I can
20 confirm that.

21 Q Then do you have the reply bundle? A. I do.

22 Q If you turn to Tab 4 in the reply bundle you should find another statement, and if you turn to
23 the back of it, there is the date of 9 November, 2004. Can you confirm that that is your
24 statement? A. I can confirm that that is my statement.

25 Q Then, thirdly, and perhaps most relevantly to today, do you have another bundle with, I
26 think, both your statement and Mr. Jeffrey's statement in it? A. I do.

27 Q In my bundle there is a Tab 1, enclosing a statement. Then there are seven further tabs, A to
28 G, under the headings 1 to 8, including annexes. My copy has got a certified copy of the
29 original on the first page, dated 7 April, 2006. Then, if you turn through to p.14, there is a
30 signature and a date of 7 April, 2006. Can you confirm that that is your statement? A.
31 I can, and the annexes attached to it as well.

32 Q Can you confirm that those statements are, to the best of your knowledge and belief, true?
33 A. They are indeed.

1 Q Just one other question: you will have seen the pleadings in this case. There are some issues
2 about change of position. Insofar as there are any inconsistencies between the various
3 statements, could you give the Tribunal any indication of how that has come about? A.
4 I am certainly happy to address specific points where there is a view that I have changed
5 position, but in general my attitude throughout these proceedings – and, indeed, from the
6 very start of this in 1995 – was that we sought the facts and as and when we got the facts,
7 we would, if necessary, adjust our positions. As a professional scientist I can hold to no
8 other course of action. Of course, over the course of these proceedings, we have been
9 given a significant amount of information that we did not possess when I drew up the
10 original notice of appeal.

11 Q Those were my questions. I do not know if there are any other questions from the Tribunal?
12 THE PRESIDENT: Not at this stage. Thank you.

13
14 Cross-examined by Mr. Vadjia

15 Q Dr. Bryan, can I just begin by asking you a question following on from the answer you gave
16 a moment ago? I think you said – and indeed your first witness statement tells us – you are
17 a qualified water scientist. You have a scientific background. A. That is correct.

18 MR. THOMPSON: Am I right that you have got no formal qualification in corporate finance; is
19 that right? A. That's correct.

20 Q Or any formal qualification in economics; is that correct? A. That's correct, yes.

21 Q Now, so far as Shotton is concerned, do I take it that you have been intimately involved in
22 the arrangements between Albion and Shotton since inception. I mean, you know all that is
23 going on; is that right? A. Since 1995, yes.

24 Q What I would like to do is to start off by asking you some questions on treatment costs. Did
25 you hear my opening this morning? A. I did indeed, yes.

26 Q What I would like to do is to begin by looking at average treatment costs, because you will
27 remember that what you have done is calculated treatment costs both on an average and on
28 a stand-alone basis. What I would like to do is to pick up the skeleton ---- Do you have the
29 Albion skeleton for this hearing? A. I do not, but I have it in my file ----

30 Q I would like you to go to para. 68 of that, Dr. Bryan. Ashgrove treatment costs. Albion's
31 notice of appeal – and I think you drafted the notice of appeal yourself, did you not? A.
32 I did, yes.

33 Q -- makes it clear that it considered 1p per cubic metre to be a generous estimate for
34 treatment costs. Is that still your view today – that that is a generous estimate? A. It

1 was pointed out subsequent ---- in terms of the Authority's defence that that estimate was
2 deficient ----

3 Q Sorry. Which estimate? A. The 1p in relation to the cost of return on capital. The 1p
4 was actually drawn from the Director's (as he then was) own estimate of operating costs for
5 Ashgrove that he used in his decision. Following that observation from the then Director,
6 we did indeed look again at the points he made and we revised that estimate to 2p in our
7 reply.

8 Q Do you have a copy of your notice of appeal? Can I ask you to go to para. 174? You say
9 there that it is suggested that 1p is a generous estimate of treatment costs. You are saying
10 that that was simply based on operating costs. Is that your position now? Did you know that
11 when you put forward the figure of 1p that it was operating cost or did you think it was
12 operating in capital? A. It is certainly the case that when OFWAT commented that we
13 had ----

14 Q Could you just answer my question? When you put forward the figure, did you put forward
15 a figure that was just operating or ---- A. I think we believed that that was just
16 operating costs.

17 Q Just operating costs. So, we should really say that it is 1p as a generous estimate of
18 treatment costs, operating costs only. Is that effectively what you were saying there? A.
19 Operating costs excluding costs of capital, yes.

20 Q You then refer in the next sentence, "OFWAT's own calculation of the cost of an equivalent
21 operation is 2p". What costs were you referring to there – 2p? A. I would have to
22 remind myself of the actual reference to the decision. This was in that part of the decision, I
23 believe.

24 Q The decision reached was that the costs were 3.2p. A. This was the annex to the
25 decision which talked about essential facilities.

26 THE PRESIDENT: We probably need to look at the document, do we not? 1-105-17D.

27 MR. VAJDA: We do. That is to be found annexed to the notice of appeal. If you go to p.105
28 you will find it there. It is appended to Dr. Bryan's notice of appeal. This is the decision.
29 It is effectively Annex 1. I am looking at it in the annex to the notice of appeal, sir. If you
30 go to p.105 of the first annex, that is 105 of the decision. In fact, what we are looking at is
31 the figure of 2p that OFWAT was referring to – it was simply an operating cost. A.
32 Indeed, I can see that.

33 Q It does not include capital at all, does it? A. It appears not to, no.

1 Q That is right. So, when we go back to 174, I think what you are telling us now – and
2 please tell me if I have got this wrong – is that although you did not actually say so in the
3 notice of appeal, all the figures that you are referring to at para. 174 you now accept are
4 simply operating costs and make no allowance for cost of capital. A. I do accept that.

5 Q Thank you. Did you know that at the time? A. No.

6 Q You did not know that. What is the greatest cost driver in the industry? What percentage
7 of costs in the industry are capital, roughly? A. Overall about 30 percent. 30 to 40
8 percent.

9 Q And you did not think it was necessary to refer to that in your notice of appeal? A. I
10 think that was an error.

11 Q It was an error. Yes. Thank you. I think you may actually under-state the importance of
12 capital costs in the industry. Can I just remind you of what you say in your most recent
13 witness statement? Can I ask you to look at para. 13? I take it you would accept what you
14 say there – that capital costs are a significant costs driver. You would agree with that,
15 would you not? A. I would.

16 Q You then had, if I can put it this way, Dr. Bryan (and this is simply for simplicity), what I
17 call Methodology 3, which is the costs recovery. Can we look at how you put that in your
18 notice of appeal? Pages 172 – 173. This is the two paragraphs that we have looked at.
19 There again you are simply looking at operating costs; is that correct? A. The point I
20 am making there is that if the Director, as he claimed, examined Dwr Cymru’s treatment
21 costs I was assuming he would do a thorough job of it.

22 Q Let us just see what you put in the reply. Could I ask you to look at the Albion reply to
23 what the Director said on this? When I say ‘the reply’, you will recall that there were, if
24 you like, the two replies: there was the reply drafted by your counsel, and then there was an
25 annex to that reply. Do you remember? A. I do, yes.

26 Q Did you draft the reply to the Director’s defence – the annex? A. I did.

27 Q Could I ask you to turn to p.34 of the document that you drafted? Perhaps you could just
28 read to yourself paras. 104 and 105 of what the Director says. (After a pause): As I
29 understand it, you accept that the Director makes a reasonable point about the return on
30 capital; is that right? A. I agree that our calculation did not include return on capital.

31 Q Thank you. What I would like to do is to move on to another topic. We are still looking at
32 treatment costs, but what I would like to look at is the percentage cost of treating non-
33 potable and potable water. Perhaps the easiest way to pick this up is if we can look at your
34 most recent witness statement at paras. 10 onwards where you deal with the cost of partial

1 treatment. You will recall that the figure that the director used in his decision was 15.2
2 percent. Do you remember that? A. Indeed I do.

3 Q The point that I think you are making at paras. 10 to 15, or 10 to 16, here is that he should
4 have in fact come to a figure of 11.5 percent as opposed to 15 percent; is that right? That is
5 the point. That is the big point you are making here? A. No. That is the partial point.
6 The main point was that the Director did not appear to have examined the Dwr Cymru
7 justification, and failed to spot that one of the two non-potable works that were used as
8 comparators does not actually exist. As far as we know, from the evidence that has been
9 laid before this Tribunal, Welsh Water only has one non-potable works, and yet the exercise
10 that the Director used at face value in his decision - and has I think stuck to ever since - was
11 based on a comparison of two non-potable treatment works, where I think the second is
12 perhaps a construct.

13 Q I do not want to get too hung up on the deal of it, but I just put it to you so you know what
14 our understanding is: what the Director did was that he did a comparison between two non-
15 potable treatment works, one of which was Ashgrove, which was wholly non-potable, and
16 another treatment works which was both potable and non-potable. Would you agree with
17 that or not? A. No, I would not.

18 Q Okay. Fair enough. I am not going to quarrel with you on that.

19 THE PRESIDENT: Surely it can be agreed as to what the facts are.

20 MR. VAJDA: What is important is now the percentage. Can you explain to me how the
21 Director reached the percentage of 15 percent? A. My understanding is that he did not
22 - that it was a figure that was given to him by Dwr Cymru and that he accepted without
23 question.

24 Q What? He plucked it from the air? A. No. Dwr Cymru presented him with a
25 calculation, and said, "This is the percentage that we are using in our new non-potable tariff.
26 This is the basis for it". As far as I can see from the evidence that we have seen that has
27 been made available to the Tribunal, the Director did not have any input or make any
28 changes to that calculation and has not, as far as I know challenged or commented on any
29 aspect of it.

30 Q Let me put this to you: as I understand it, what Dwr Cymru did, and what the Director
31 accepted, was it took the average difference between two non-potable treatment works and
32 eight potable treatment works. What they then arrived at, they looked at ---- So, they
33 looked at a number of plants, and they also - and this is what I am going to be coming to in
34 a moment - they looked at the difference both on an actual and theoretical basis. What is the

1 significance of looking at something by reference to the actual or theoretical basis? Why do
2 people look at something on a theoretical basis here?

3 THE PRESIDENT: It is a little bit difficult for this witness to know what Dwr Cymru did,
4 because it is in your client's knowledge. You need to lay the ground as to what exactly we
5 are talking about; look at any relevant document ----

6 MR. VAJDA: What I am looking at, sir ----- This witness has given detailed evidence as to why
7 it should be 11.2 percent. In order to understand why it is 11.2 percent, the starting point is
8 why it was 15 percent ----

9 THE PRESIDENT: I think it is 11.5 percent.

10 MR. VAJDA: I beg your pardon. 11.5 percent. What I am doing, sir, is putting to this
11 witness what actually happened. I want to ask him a question on his calculation. A. I
12 can try to explain what I think Dwr Cymru did. They clearly have information, and I suspect
13 much of the information they have we still do not possess. We know they have accounting
14 information on most, if not all, of their treatment works. They certainly have it for Ashgrove
15 because that has latterly been disclosed. In terms of this exercise, they did not use the
16 accounting information in the sense of the cost of those various cost centres. They used a
17 figure which is described as the current cost valuation for nine potable treatment works, one
18 non-potable treatment works that we suspected – and now know to be Ashgrove - and
19 another non-potable treatment works that you now describe as an exercise which (I am not
20 quite sure how) takes a potable treatment works and ----

21 Q You are saying that they did it on a CCV basis; is that right? A. I am saying that what
22 they then appear to have done is take the current cost valuation, which I assume they take
23 from their financial records; they use that as the basis for a depreciation charge; and they
24 used a very crude rule of thumb which was to split the depreciation ---- to split the CCV, the
25 current cost value, into civil works (i.e. buildings, concrete primarily) and mechanical and
26 electrical works. They then calculated a depreciation charge based on, if memory serves me
27 correctly, a sixty year life for civil works and, I think, a twenty year life – and I may be
28 wrong on that – for mechanical and electrical. What they then did was they calculated, if
29 you like, a depreciation charge per unit of water as a proxy for the totality of treatment
30 costs. I have seen no evidence as to why depreciation should be a proxy for total treatment
31 costs, but that is what they did. They did that for two measures – one which was the actual
32 output of the works; the other, which was the theoretical.

33 Q Yes, the hypotheticals. A. The figure of 15 percent that they came up with was, as I
34 understand it, the simply arithmetic average of those two figures.

1 Q That is very helpful. I entirely agree. Now, two points arise. First of all, can I just ask you
2 to look at para. 10 of your statement, because you have just told us a moment ago that this
3 was done on a CCV basis. A. Yes.

4 Q But, you say at para. 10, “This depreciation charge was taken as a proxy for treatment costs
5 and appears to have been based on a gross MEAV of each works”. Now, which was it?
6 Why did you say MEA in your statement, and you are now telling us it is CCV? A. I
7 had the view when I wrote that statement, and I am also of the view, that the two figures
8 appear to be broadly comparable.

9 Q So, your position is, just so that I understand this, that you are telling the Tribunal now that
10 this was based on a CCV figure. We agree with you that it was based on it. But, you are
11 also telling the Tribunal, are you, that actually CCV and MEA are interchangeable. Is that
12 right? A. I am sure that from an accounting point of view they are not.

13 Q I just would like to have your evidence ---- A. But, in terms of my analysis of the
14 evidence that we have – which is scant – and which relies heavily on the asset register of
15 Dwr Cymru, as presented as part of its periodic review business plan – which is the only
16 figure we really have for the totality of that asset stock – it appears to be that there is a
17 consistency between the CCV values expressed by Dwr Cymru in reaching the 15.2 percent
18 and the MEA values that exist in Dwr Cymru’s asset register for the totality of its water
19 treatment works. Now, that is my view. Clearly, Dwr Cymru have those figures, and we
20 have, on numerous occasions, asked them for the MEA figures for treatment works. But, so
21 far they have not been produced.

22 Q But you accept now that the Dwr Cymru exercise was done on CCV figures. A. That
23 is what it said on the paper, yes.

24 Q Yes. The second point that I want to ask you about – because you have, so far as I can
25 understand it, summarised accurately what Dwr Cymru did and what the Authority did in
26 reaching the 15.2 percent ---- Could you explain to the Tribunal what you did to get to the
27 11.5 percent? What was the difference? A. The 11.5 percent was based on the actual
28 output.

29 Q That is right – because what Dwr Cymru did is that they looked at both actual and
30 hypothetical and did an average. A. Indeed.

31 Q They did not just look at actual. You looked at actual . Just so we get this right ---- They
32 took two plants comparing with eight plants, and you were just looking at Ashgrove on its
33 own; is that right? A. Well, Ashgrove is the only non-potable plant.

1 Q You are looking at actual. Now, why did you look at actual rather than hypothetical? Why
2 is actual more reliable than hypothetical here? A. Because actual is audited. Actual is
3 presented in various June returns. Actual – we can see what the output of the plants is.
4 Those volumes can be checked and cross-checked against, for example, distribution input.
5 So, we can test that. Theoretical/hypothetical could be anything. It is, for example,
6 theoretically possible for Ashgrove to produce 32 megalitres a day, so we believe. We know
7 we couldn't get 32 megalitres through the pipeline. So, the validity of theoretical output is
8 questionable. There is another issue, which is that if a water company (or, indeed, any
9 company) is inefficient in the design of its treatment plants, in this case, and builds a plant
10 that is far too large for its needs, and it gets it wrong, it does not strike me that there is any
11 particular merit in rewarding that company for its inefficiency. Any skewing of costs, of
12 charges in this case, to reflect inefficient hypothetical outputs which cannot be tested, and
13 for which no evidence has been presented, is, in my view, dangerous. That is why I
14 preferred to go for something which we could test.

15 Q Can I ask you this, because we are looking here at capital costs: when one is looking to
16 establish what the capital cost is, does one look at the cost of building it, or the cost of
17 actual throughput? A. The cost of building it.

18 Q Yes. So, one looks at theoretical output, does one not? A. No. One looks at the
19 specification for the plant as built.

20 Q Yes. But if one is looking at not what actually happens ----- A. You are telling me
21 that that is the same as theoretical output. I am saying I do not have any evidence on which
22 to test that.

23 Q Just so the Tribunal understands the debate, you say you took action because you say that is
24 a verifiable figure. I am putting to you – and please tell me whether you accept this or not
25 – that when one is looking at establishing the capital cost, it is more accurate, in a sense, to
26 take the theoretical output because that is actually what you ---- You build it to that
27 specification, whether or not you use 80 percent/70 percent of that capacity. Do you
28 understand the point I am making? A. Clearly the capital costs will reflect the as-built
29 structure.

30 Q You can then understand why the Authority and Dwr Cymru then took an average which
31 was half-way between actual and hypothetical. A. I think Dwr Cymru took it, and the
32 Authority accepted it, yes.

33 Q Yes. What I would like to do next, still on treatment costs, is move to stand-alone. Could I
34 ask you to go to para. 17 of your latest witness statement? You say, “As a cross-check on

1 this conclusion, in Annex D to this statement I consider the stand-alone costs of treatment at
2 the Ashgrove treatment works based on Dwr Cymru's own MEAV ----“ So, you are
3 relying on an MEAV. Let us go to Annex D at p.80. You have that table? A. I do.

4 Q What I am going to focus on for the moment is the ROCE figure – return on capital
5 employed. Do you see that? A. Yes.

6 Q Ashgrove waste treatment . . . Am I right that that is a return of 0.8 percent? A. That's
7 correct.

8 Q What we would now like to do is to look at Annex B, para. 102. This is your table. What I
9 want to focus on is the last line of that table. Do you have that, sir?

10 THE PRESIDENT: Yes, we do.

11 MR. VAJDA: Dwr Cymru asset register – 2002/2003 – Gross MEA - £1.449 million.

12 THE PRESIDENT: These figures are now for Ashgrove as a whole? No? They are for the
13 water treatment works?

14 MR. VAJDA: This is for water treatment, sir. (To the witness): That is wrong, is it not? There
15 is no gross MEA? A. No. That is incorrect. That is an error. That should read the CCV
16 that was disclosed ----

17 Q That is quite important because when you look at that table, effectively all the other
18 valuations there go from 2.5 to 7.5, and the one at the bottom is, in a sense ---- That you
19 have accepted is wrong. A. I've accepted that I've given it the wrong label. It should
20 be CCV, yes.

21 Q Just so that we can nail this point, can I ask the witness and the Tribunal to go to SA11,
22 which is Document 11, which is annexed to the skeleton argument at the last hearing?

23 THE PRESIDENT: I think over the adjournment, Mr. Vadja, it is going to be useful to get the
24 availability for the witness of the documents that you are going to come to so that we do not
25 waste time.

26 MR. VAJDA: Albion's skeleton for the last hearing. A. Are you referring to the 15.2
27 calculation?

28 Q I have just been reminded, sir, that I may have mistakenly said 'waste treatment'. It was
29 'water treatment'.

30 THE PRESIDENT: We had noticed that, Mr. Vadja. Not to worry.

31 MR. VAJDA: If we can go then to SA11, Annex 5. These were all figures you had before the
32 last hearing, did you not? A. I did, yes.

33 Q If we go to SA11 we see there a figure – civil and M&E and then a figure of 1449 CCV.
34 That is the CCV figure for Ashgrove, is it not? A. Yes.

1 Q It is important the Tribunal has that. That is the figure. That is where the 1449 comes from.
2 THE PRESIDENT: Yes. I have got quite a lot of markings on this. We discussed it in some
3 detail at the last hearing.
4 MR. VAJDA: The Tribunal has the advantage of me. (To the witness): If we just go to the
5 skeleton for this hearing, to para. 70(3), do you see what is said there? “Dwr Cymru has a
6 gross MEA value for the Ashgrove treatment works with an asset register of 1449.” That is
7 completely wrong, is it not? We have seen that. We can ignore that.
8 THE PRESIDENT: Have you got an MEA value in your asset register for Ashgrove?
9 MR. VAJDA: No. This is a fundamental misconception because there has been an elision of
10 CCV and MEA and this is rather important.
11 THE PRESIDENT: There must be something in the asset register ---- A. I think I might be
12 able to help the Tribunal on this because clearly I have done as much as I can to test the
13 various figures that I have put to the Tribunal. I could explain why ----
14 MR. VAJDA: All at the moment I am interested in, Dr. Bryan, is that we have seen at SA11 the
15 CCV figure. A. Correct.
16 Q It is wrong to regard that as an MEA figure, is it not? A. I don’t believe so. I happen
17 to believe the two are very close.
18 Q Right. Well, that is another area we will get into. But, you agree with me that there is
19 nowhere that one can find – or you have been able to find in Dwr Cymru’s asset register
20 which shows an MEA value of the treatment plants at £1.49 million?
21 MR. THOMPSON: I am sorry, I do not want to interrupt but it does seem to me that it would be
22 fair to Dr. Bryan to take him to the relevant part of his evidence, which is p.74 of Annex B,
23 para.98, where he sets out his position on this question.
24 MR. VAJDA: I am going to take him to that, Mr. Thompson need have no fears. We will be
25 coming to that. (To the witness): While we are still on the skeleton can we just read at the
26 top of para.70, your counsel suggests – do you see it – it says “... three significant pieces of
27 evidence emerge from that statement”, that is Mr. Jones’s second witness statement. Do you
28 see that? A. Yes.
29 Q But in fact, the evidence of the value of Ashgrove at 1149 was, of course, in your hands
30 already at the last hearing, was it not? A. No, it was not, because it was not identified as
31 Ashgrove, and it took some considerable time and more ----
32 Q I see, so you ---- A. –to confirm that that was Ashgrove.

1 Q I see, yes, it was effectively anonymised? A. It was indeed. We had our suspicions, but
2 it was not clarified until after Mr. Jones' witness statement. So I think that paragraph that
3 you refer to is not misleading in that ...

4 Q Now, could I ask you to take up Mr. Jones's witness bundle? What I would like to do is to
5 take you to a letter annexed to his third witness statement.

6 THE PRESIDENT: Yes, which annex?

7 MR. VAJDA: This is CAJ-I to CAJ-III, it is the letter of 1st March, if I could ask you to look at
8 p.2 of that letter?

9 THE PRESIDENT: Yes.

10 MR. VAJDA: (To the witness) Have you seen this letter, I mean this was a letter addressed to
11 you, was it not? A. Yes, I have seen it, yes.

12 Q And there was a question, which was your question: "Please provide asset register relating
13 to Ashgrove system."

14 THE PRESIDENT: Mr. Vajda, can we just quickly read it to ourselves, see what is going on
15 here?

16 MR. VAJDA: Yes, absolutely.

17 THE PRESIDENT: (After a pause) Right, well we have read that explanation.

18 MR. VAJDA: (To the witness) What is being said there, do you agree, is that the figure, and that
19 we have seen the figure for Ashgrove £1.49 million, is a backward looking figure, it is for
20 historic cost purposes only? It is not forward looking. Do you agree with that? A. I am
21 not certain on what basis it has been calculated.

22 Q On what basis do you think it has been calculated? A. I do not think I am qualified to say
23 that. All I can say is that it appears to be consistent with my view on MEA values for the
24 asset stock representing Dŵr Cymru's water treatment works.

25 Q Well if you are not qualified to assess on what basis it has been calculated how can you say
26 it is equivalent to MEA value? A. Simply because I know what the total value of Dŵr
27 Cymru's water treatment works are, that is a matter of public record – certainly a matter of
28 record before this Tribunal – and I now have a range of CCV values, however they have
29 been calculated, and we also have details of the outputs of those works whose CCV values
30 are obtained, so I can then, as a scientist rather than an accountant, look at the totality of the
31 asset value that Dŵr Cymru recognise in their returns to OFWAT. I can look at the total
32 output of the works against which that asset value is ascribed. I can then look at the subset
33 of the works represented by the works that are anonymised in SA11 and their output, and
34 there is a reasonable – I will not say it is exact – there is a reasonable comparison between

1 CCV as expressed in this table, and my calculation of MEA based on the proportion of
2 output for which these works are responsible.

3 Q Would the Tribunal permit me one more question before the short adjournment?

4 THE PRESIDENT: Can I just ask, I just need some help as to where to put my finger on it .

5 There is, as I have understood that last answer, in the Dŵr Cymru's returns of MEA values,
6 a global figure for water treatment works, is that correct?

7 MR. VAJDA: Yes, there is, it is in Mr. Jones' first witness statement.

8 THE PRESIDENT: Thank you.

9 MR. VAJDA: One of the annexes to that. Just let me see if I have followed what is being said.

10 We have a total figure so you are trying to work out from that total some rough guide to
11 any difference between potable and non-potable, and if you take the various throughputs
12 that you know you have got, which you think you have got, the proportion that the one bears
13 to the other, whether expressed in MEA value, or expressed in CC value, according to you
14 is not that different? A. That is correct. There is a difference, but it is not a significant
15 difference. It is certainly not of the order of twofold or more, which is the difference
16 between the 1.449 and Mr. Jones' estimate of 3.25 or thereabouts.

17 THE PRESIDENT: Sorry, Mr. Vajda.

18 MR. VAJDA: No, I am very grateful, because this is a constructive exercise, we all gave ----

19 THE PRESIDENT: Well I am rather slower than everybody else, and I take some time to get on
20 top of what is being said.

21 MR. VAJDA: (To the witness) You are basing, and we have seen that table that I took you to in
22 the annex to your latest witness statement. It is now accepted that you are looking at that
23 CCV figure? A. Yes.

24 Q My question is this: are you taking that CCV figure to be forward looking or backward
25 looking? A. I am taking it to represent the value of the asset against which Dŵr Cymru
26 can reasonably expect to earn a return. I am not sure that is the answer to your question, but
27 you are leading into areas where I am not sure I am qualified to answer in terms of pure
28 accountancy. I am looking at this rather simplistically as a scientist in terms of what is the
29 value to Dŵr Cymru of this asset? What is a reasonable return on that asset value that is
30 consistent with the return they earn on their other assets.

31 Q Dr. Bryan, the reason I am asking you these somewhat technical questions, you say "I am
32 only a simple scientist" – I am only a simple barrister – you have actually given a lot of
33 detailed accountancy/economic evidence where you reach certain conclusions which are

1 highly contested and I have to put these questions to you, because this is a very big financial
2 case you are putting. A. Yes.

3 Q And you are saying MEA is equivalent to CCV and all the rest of it and a lot of that we do
4 not accept, so I have to put these questions to you. I hope you understand that? A. Of
5 course I understand.

6 Q Now, just getting back, because we are looking here at the question of stand-alone cost, I
7 ask you again as you admitted you have not answered my question, are you taking the CCV
8 to be forward or backward looking – yes, or no? A. I think in the terms that you phrase it,
9 it must be backward looking. It must be the value that exists within the system as it stands.

10 Q Thank you. Can I, just before we break, give you, Sir, the reference because you asked me
11 a question about the MEA register, if I could just give you that, that is at Jones 1, para.53
12 and following, where he deals with this very question, which I know is a question which has
13 been troubling the Tribunal. It is one we will be dealing with when I come to examine Mr.
14 Jones, but that is where it is in the evidence.

15 THE PRESIDENT: Thank you for that, Mr Vajda. As I followed this part of the debate, and I
16 want you to put me right if I have got it wrong, when we come back. The issue here is not
17 so much whether a CCV value is different from an MEA value, though apparently there is,
18 though I am not quite sure what the difference is yet, because a CCV value in terms of
19 current cost is, I would have thought, a sort of updated figure of some kind. The question is
20 does it make any difference depending upon which comparator you use? That is the
21 question, is it not?
22

23 MR. VAJDA: Precisely, Sir. There are two questions, there is, if you like, the first question,
24 which is what is “CCB”? That is something I will explore with Mr. Jones, because CCB
25 has a particular characteristic in the Dŵr Cymru accounts. But the second, and in a sense
26 bigger question is precisely the point that you, Sir, have put your finger on.

27 THE PRESIDENT: If you have done the comparison ----

28 MR. VAJDA: Is it right to take this figure as a comparison, whatever it is called, whatever label
29 you attach to it.

30 THE PRESIDENT: Thank you.

31 MR. VAJDA: Absolutely, the Tribunal is spot on.

32 THE PRESIDENT: Dr. Bryan, we have a rule, which I would be glad if you would observe,
33 which is not to talk about the case to anyone while you are giving evidence. Now, Mr.
34 Thompson, can I just make sure, if there is no objection – there may be an objection from

1 Mr. Vajda – do you want me to send Dr. Bryan off to have lunch by himself, or are you
2 prepared to police the rule very strictly, if you have lunch together, or if you were planning
3 to have lunch together – I do not know whether you were or not?

4 MR. THOMPSON: I indicated that there was such a rule before Dr. Bryan started giving
5 evidence. I am happy to police it either in his presence or in his absence, but it may be
6 simpler for him to go and have lunch quietly on his own and deal with all the files that ----

7 THE PRESIDENT: I think that would be proper in this case, Mr. Thompson.

8 MR. VAJDA: I concur with that, Sir.

9 THE PRESIDENT: I think we will do that.

10 MR. THOMPSON: I am happy to go and buy him some lunch!

11 THE PRESIDENT: We will follow the normal rule if we may.

12 MR. THOMPSON: What time would you like us to resume?

13 THE PRESIDENT: Shall we resume at 10 past 2?

14 MR. THOMPSON: Certainly.

15 THE PRESIDENT: Thank you.

16 (Adjourned for a short time)

17 THE PRESIDENT: Yes, Mr. Vajda?

18 MR. VAJDA: (To the witness): I would like to go back to the letter of 1st March 2006, which we
19 were looking at just before the adjournment. If you go to tab 3, which is towards the back
20 of that. A. Letter of 1st March, yes.

21 Q Then we are looking at p.2 of that letter? A. Yes.

22 Q What you were asking for here were the asset registers relating to Ashgrove? A. Yes.

23 Q What I would just like to explore with you, is the sentence in the middle of that answer.

24 “Further, and for this reason, since the bulk of the relevant assets at Ashgrove
25 were vested in Dŵr Cymru predecessor there are no corresponding entries in the
26 asset register.”

27 Do you understand what is being said there? A. Yes.

28 Q Can you just explain to the Tribunal what your understanding is of that? A. My
29 understanding of the facts behind that are that Dŵr Cymru took over operation of the
30 Ashgrove system, I believe, in 1986 but that was not formalised until after privatisation in
31 accordance with the agreement between United Utilities and Dŵr Cymru that is before the
32 Tribunal. I understand this to mean that when Dŵr Cymru took over those assets they did
33 not ascribe any value to them on their asset register.

1 Q And if we just go a few pages further on – I apologise this is not numbered – if you go to
2 the end of the letter, and then there is another letter of 20th April. Then, do you see there are
3 actually some asset registers behind that? A. Yes.

4 Q What I would like you to do is to go to p.3 of the fax. It is the second table. The fax header
5 is p.3 and then if you look at “Asset class” that is a figure of £825,000-odd? A. Yes.

6 Q Can you tell the Tribunal what that figure is? A. I have no idea.

7 Q You have no idea what that figure means? A. I can only assume because the headings are
8 not legible, I can only assume that that is some sort of gross figure, that there is in the
9 second column some deduction which one could guess is depreciation and then there
10 appears to be a net figure in the third column, and the maths, at least, works for that.

11 Q Have you ever looked at this in detail before? Is this the first time you have looked at this?
12 A. I have looked at it, given the poor quality of it and the impossibility of understanding the
13 headings, I have looked at it, yes.

14 Q What did you make of it when you looked at it? What are you saying that £825,000 in your
15 view represents? A. If one looks at the ----

16 Q If I can put a question to you and you can perhaps agree or disagree. Would you accept that
17 that was the amount of money that has been spent by Dŵr Cymru – in nominal terms –
18 since the asset was vested in it, since about 1986. Would you accept that, or are you not in a
19 position to say? A. That seems to contradict Mr. Jones – I think it is Mr. Jones’s
20 evidence – to the effect that this CCV is the amount of money spent by Dŵr Cymru.

21 Q No, the CCV is the amount, that is done when you adjust it for inflation. A. So you are
22 suggesting that the CCV is this figure **here** adjusted for inflation, are you?

23 Q Yes, this is the unadjusted figure for inflation. Would you accept that? A. I have no
24 evidence on which to base that. The only evidence I have is entries in Miss Cross’s witness
25 statement that there are a number of activities, a number of investments undertaken at
26 Ashgrove, no costs against those individual investments, some like resurfacing the road one
27 would expect would be relatively low cost, but I really have nothing against which to
28 measure this if you are asking ----

29 Q Do you think the 825 includes an element for construction costs in that or not? A. There
30 has been no construction at Ashgrove since 1986 that I can detect, so if what you are telling
31 me – and I take at face value – is that there was a nil entry when the assets were transferred,
32 presumably this is representative of the costs since then.

33 Q Yes, but does not show construction costs, you would agree with that? A. I suspect it
34 does not, but I do not know whether they capitalise things like roads and security for ----

1 Q I am just talking about construction, you have answered my question, no, it does not
2 include construction costs? A. It does not look as if it does, no.

3 Q Could I ask the Tribunal and the witness now – if we keep that open, but go to your witness
4 statement, Dr. Bryan ----

5 THE PRESIDENT: Just before we do that, Mr. Vajda, are you going to enlighten us at some
6 point as to what these figures are, because there are two pages. They are headed “Book
7 depreciation” in both cases. One has various figures that seem to come to a net figure – I
8 cannot quite read it but it looks like 88,000 or 82,000, or something of that kind. Then the
9 following page there is another lot of figures, which seem to show something different.
10 They seem to start with a figure of around 825,000, and then you knock off 500,000 for
11 depreciation and get to 312,000 for something or other?

12 MR. VAJDA: That is one of the reasons ----

13 THE PRESIDENT: It is quite a laborious way to get out something that can probably be
14 explained quite shortly.

15 MR. VAJDA: The figure, Sir, that I would like you to concentrate on at the moment is the 825,
16 and what I would like to do is now go and I hope this will become clear, if we go now to Dr.
17 Bryan’s witness statement at annex B to his fourth witness statement. A. I have just
18 spotted something which I think helps answer your previous question which is on that
19 second table **there**, there is an entry which looks as though it is the third line down – “1st
20 April 1957 Ashgrove debt, £160,000.” So I think in answer to your question does the 825
21 include construction cost, the answer is yes it does, because clearly that debt is what was
22 left of the construction costs that had not been paid off by United Utilities. I apologise I got
23 that previous answer somewhat wrong.

24 MR. VAJDA: Could I ask you now to turn to annex B of your witness statement? A. Yes.

25 Q You see, you rely, Dr. Bryan, on the figure of £825,860 do you not to get to – this is your
26 fourth source? A. Yes.

27 Q The fourth source of information, and that you say from it appears the gross asset value is
28 £825,000? A. Yes.

29 Q So you are plainly relying on that – how do you get from the 825 to the 1.449? A. I do
30 not. Those are two different figures. It struck me that as everything else, and certainly the
31 returns that I was proposing to use were based on MEA that it behoved me to look as far as
32 I could for a figure that approximated to MEA, which is what I have done. What I am
33 asking you now is what you say in the second sentence of 101. Are you saying that the

1 gross asset value of Ashgrove then – that is the figure you are relying on, 825? A. That is
2 the figure that is in the evidence you have just pointed me to.

3 Q You are saying that is to be equated to the gross asset value, is that what you are saying?

4 A. That appears to what the accounts say, if I have read those accounts correctly.

5 Q Can I just explore this? Supposing I am given a car by a friend for free, and then is looking
6 for how much is it going to cost me to replace the car, how would you go about that?

7 Would it be relevant that I had been given the car for free, or not? A. I do not think it
8 would, no.

9 Q One is having a forward looking analysis and one has ---- A. In that particular case, yes.

10 THE PRESIDENT: I am sorry to interrupt you, can you just remind me where the figure of 1.449
11 comes from, on what you have based that?

12 MR. VAJDA: It comes from the evidence disclosed by Welsh Water as the basis for the 15.2 per
13 cent. treatment cost.

14 THE PRESIDENT: I see, yes of course.

15 MR. VAJDA: SA11.

16 THE PRESIDENT: It was the CCB thing.

17 MR. VAJDA: Yes. (To the witness) What you have been trying to do – we are looking at stand
18 alone costs. You have been looking at the capital value looking forward, that is what it has
19 been trying to do, is it not? A. I have been trying to create an MEA value.

20 Q Looking forward? A. That is ----

21 Q Can I just take you to the beginning of Annex B? If I can just ask you to read to yourself
22 para.2? A. (After a pause) Yes.

23 Q What you are doing is you are agreeing with him as to the definition of MEA there? A.
24 Yes.

25 Q And then if I can take you to para.74 on p.70 do you agree with Mr. Jones that the definition
26 of MEA is "... the minimum it would cost the undertaker to replicate the required operating
27 capability of the asset or system looking forward?" A. Yes.

28 Q So it is a forward looking exercise, and you have agreed with me a moment ago that it is
29 irrelevant on a forward looking exercise whether or not the asset in question has been gifted
30 or not? A. Yes.

31 Q Perhaps you could answer this next question which arises out of a question the President put
32 to you a moment ago when he asked you about where did you get the figure of 1.449 from?
33 We know it is from SA11. Could you tell the Tribunal what you understand, your

1 understanding of CCV is as used in SA11? A. I understand it to be the future value of
2 those assets or the value of those assets expressed in current cost terms.

3 Q So you take that CCV to be a forward looking – are you saying it is a forward looking
4 figure? A. I do not know. All I know is that the CCV is comparable to the MEA in terms
5 of the consistency with the figures published by Welsh, and that MEA is certainly forward
6 looking, as I have accepted ----

7 Q There is no dispute. Everybody agrees that MEA is forward looking, and you have accepted
8 Mr. Jones's approach. What I would like to explore with you is what you think the 1.449
9 million actually equates to in SA11? What does that actually show? A. It shows that
10 Welsh recognise that that asset has that value within their books. I do not know, I cannot go
11 behind that and pretend that I understand precisely the difference in Welsh's own mind
12 between that CCV, that current cost value, and the values that they must have in order to
13 report to OFWAT on the totality of their MEA costs for treatment works. All I can say to
14 you is that there is a consistency between the two measures of costs.

15 Q I have to press you a little further on this, Dr. Bryan. You say that it shows that that is the
16 value that Dŵr Cymru attributes to that. Where is the evidence to support that? That is your
17 interpretation, but is there actually any document that you have found to support your
18 interpretation? A. We have struggled for 11 years to find evidence. This is evidence that
19 emerged after the Appeal was lodged. It was evidence volunteered by Dŵr Cymru and it is
20 evidence on valuation. I took it at face value.

21 Q I have to put it to you and you can obviously agree or disagree or tell the Tribunal you do
22 not know, I put it to you that CCV, as used by Dŵr Cymru, is the amount that has been
23 spent on the asset since it was vested in Dŵr Cymru and adjusted for RPI. Do you agree or
24 disagree with that? A. I cannot tell you because I have not seen the calculations. You are
25 telling me, and it is the first that I have actually thought about it that it represents the
26 £825,000 adjusted for inflation. If I knew when that £825,000 was spent then I am sure I
27 could do the indexation myself, and I may well come up with the CCV.

28 Q It is quite important stuff, Dr. Bryan ----

29 THE PRESIDENT: Dr. Bryan is working on figures that you yourself produced and which you
30 submitted to the Director, and it is a bit difficult for us to follow all this without knowing
31 what the figures are and what your clients have actually got?

32 MR. VAJDA: What my clients have actually got is before the Tribunal. What I must be entitled
33 to do is to cross-examine Dr. Bryan on the use he has made of this information to
34 undermine the decision in saying that the decision on excessive prices was completely off

1 the radar screen and that the MEA, and indeed we see at 102, Sir, it says 1.449 was the
2 gross MEA.

3 THE PRESIDENT: Well what I understood the position to be, and this is the point we were on I
4 think just before lunch was that the company thought it right in the course of the preparation
5 of the new non-potable tariff in whenever it was, 2003 I think, to do a calculation based on
6 CCV values, as a proxy for indicating differences in treatment costs and what Dr. Bryan has
7 said so far is that he accepts that when he referred in his various statements to MEA to
8 1.449 that should really be CCV, but that according to him, and these are calculations we
9 have not yet seen as far as I know, if you were to do a calculation on what he thinks is MEA
10 values on a like for like basis, you would get a rather similar figure. I would have thought
11 that is the point we need to explore because that is the critical point, is it not?

12 MR. VAJDA: With respect, sir, that is the point I am exploring.

13 THE PRESIDENT: It is taking a little while to get there. Just so that I can follow what is going
14 on ... you are saying that if we take the £825,000 on this document apparently taken off the
15 asset register on 28 February last ... If you update from each of these dates by inflation –
16 that is to say, from 1 October, 1989 apparently; 1 October, 1990; 1 April, 1957(sic), etc,
17 etc., you will arrive at a figure that is 1.449. That is what you are saying.

18 MR. VAJDA: Yes. It is not just me who is saying that, sir.

19 THE PRESIDENT: Your company.

20 MR. VAJDA: That is in evidence, and that is what I am coming to. Perhaps if we could go to
21 Jones 3, then Dr. Bryan can have an opportunity of commenting on this. Dr. Bryan, do you
22 have this document – the third witness statement of Chris Jones? A. Yes, I have it
23 here.

24 Q The relevant paragraph is para. 9. Perhaps I could ask both the Tribunal and Dr. Bryan just
25 to read to themselves paras. 9 to 12? (Pause whilst read):

26 THE PRESIDENT: Yes, but that does not quite answer the question, but I think you have
27 answered it implicitly. You are saying that if we gross up these various figures in the annex
28 to the letter of 1 March by the rate of inflation since the dates that are there, we will get to
29 1.449.

30 MR. VAJDA: Yes. Yes.

31 THE PRESIDENT: That is what you say.

32 MR. VAJDA: Yes. Absolutely. As you, sir, said before lunch, obviously, in a sense, the big
33 point here is: what is the correct value to take for the treatment works looking forward?
34 We have seen the figure that Dr. Bryan relies on is the 1.449. That is what is dealt with by

1 Mr. Jones at paras.9 to 12. The question that I put to Dr. Bryan is: what, if anything, do
2 you disagree with in paras. 9 to 12? A. I think in general terms I disagree with his
3 conclusion because my calculations suggest that there is a close relationship between CCV
4 and MEA, however the CCV figure was derived.

5 Q Just pausing there ---- Can you tell the Tribunal how there is a close relationship between
6 the CCV (however its calculation in the MEA). I have not understood that. A. Okay.
7 In trying to understand the cost base for the service that we are trying to buy I have looked
8 at all the evidence, and that means evidence from Dwr Cymru in the main because there is
9 very little evidence that OFWAT have generated. I have tried to understand, and find,
10 instances where costs are defined. As I said before lunch, what we do find in CJ4 - the
11 fourth annex to Chris Jones' first witness statement – is the asset register. That asset register
12 shows the value of the totality of Welsh Water's treatment works. The MEA value. Let us
13 be clear about definition. To be £476.3 million. Now, I fully accept that there is no
14 breakdown of that figure that is of any use in terms of further analysis from that source. So,
15 I have then looked at what we do have, which is, as you referred the Tribunal to before
16 lunch – the SA11 figures for these comparator works. Now, what I think is quite useful ----
17 If the Tribunal would not mind turning to the second page of the SA11 disclosure, and if I
18 explain to you how I have done it, then you can point out where I have gone wrong ----
19 What we now know – and it is a little confusing because the labels are taken out – is that the
20 third works down on that second page is Ashgrove. There you will find a CCV of £1.449
21 million. Now, what Welsh Water have helpfully done is ... If we turn to the bottom of that
22 same page we have two further series of calculations. These are, in fact, totals. So, the
23 calculation second from the bottom, which has civil engineering costs of £57 million or so,
24 and a CCV of £95.2 million ---- That actually represents the arithmetic total of all the
25 potable treatment works that come before – nine in total. The very bottom calculation is
26 for the total of Ashgrove and this other treatment works that is not a treatment works, but
27 was used anyway in the comparison.

28 Now, what I have done, Mr. Vadja, is that I have looked at that current cost valuation for a
29 significant sample of Dwr Cymru's water treatment works, and I have asked myself the
30 question, "How significant is that sample?" The answer to that can be found from taking
31 the output of those works, which again is helpfully calculated as 224 megalitres a day. We
32 know how much water Welsh Water's treatment plants put into supply. We know from the
33 enclosure that we have already presented to the Tribunal – and I can refer -----

1 Q I hesitate to interrupt. What we are looking at here, Dr. Bryan, is a stand-alone calculation,
2 and what I would like to know, and I am sure the Tribunal would like to know, and I ask
3 you again, is: how do you come to say that the CCV figure here is a reasonable proxy for --
4 --

5 THE PRESIDENT: He is in the middle of explaining that. A. That is what I am getting to.
6 What we know from that evidence which is already before the Tribunal is that the output of
7 these works is 224 megalitres a day. We know that the output from all Welsh Water's
8 treatments works was 894 megalitres a day. It is therefore possible to say that the ten works
9 represented here – the ten potable works – are responsible for 25 percent of Dwr Cymru's
10 output. Now, I have then taken a little leap and said that if we assume that output is
11 proportional to the value of the construction costs of the works (which is not such a huge
12 leap given that all works have to meet the same criteria set down by the Drinking Water
13 Inspectorate) we might expect 25 percent of the works represented here to be broadly
14 equivalent to 25 percent of the MEA value that Dwr Cymru publish in their own asset
15 register. Now, that MEA value, we already know, is 476.3 million. 25 percent of that is
16 119 million. I am the first to accept that the 95 million represented in CCV values is not the
17 same as 119 million, but it is close, and it is a lot closer than Mr. Jones' suggestion which is
18 that the MEA is well over twice the CCV. That is the basis upon which I was able to say
19 that the CCV is the closest thing we have to a figure that appears to stand investigation as a
20 proxy for MEA.

21 MR. VAJDA: Where do I find that in your evidence, Dr. Bryan – what you have just told me?
22 I have not found that. Can you point me to the paragraphs in your witness statement
23 explaining that? A. No, because that was a response to the arguments from Mr. Jones
24 received and the skeletons, and I only completed that work over the weekend.

25 Q But, hang on. You are relying on – and indeed your counsel is relying – both in the skeleton
26 and reply on the table at para. 102 of Annex B to your witness statement. That is what is
27 being relied on. A. Yes.

28 Q I find absolutely nothing in Annex B. You have spent a lot of time on this case, have you
29 not, Dr. Bryan? A. I have.

30 Q You have had weeks, if not months, on this. A. Years.

31 Q Years. I do not find anything coming close to what you have now explained in Annex B, or
32 anywhere else. What I do find in Annex B is simply taking the figure of 1449 and calling it
33 gross MEA. A. Yes.

1 Q. So, I have to put it to you that you are making this up on the hoof. A. No. I am using
2 evidence that has been presented by Dwr Cymru. Wherever possible, I have used evidence
3 that has been provided either by Dwr Cymru or by the Authority. I have studiously
4 avoided, as far as humanly possible, making stuff up on the hoof, but I have to tell you, in
5 all honesty, that, yes, that check on the MEA ---- on the CCV versus MEA, I only
6 conducted over the weekend.

7 Q Can I ask you this: going back to my car analogy ---- I get a car which is worth £20,000. I
8 spend £1,000 fixing the gearbox of the car. All right? A. Yes.

9 Q Is the £1,000 relevant to determining the replacement value of the car, and how is it relevant
10 when one is looking at how much it would cost ---- how much I need to spend to replicate
11 the car? Does one look just at the £1,000? A. I doubt whether a car without a gearbox
12 is worth £20,000. So, I suspect that there is ---- I am not sure that I am competent to ----

13 Q The CCV figure is effectively what has been spent on the asset since it has been acquired by
14 Dwr Cymru. My point is: how can that tell you what the forward-looking stand-alone cost
15 for replicating that asset is? A. The only answer is: I don't know.

16 Q Right. Thank you.

17 PROFESSOR PICKERING: Could I just ask: in relation to the table that we are finding difficult
18 to read in Mr. Jones' first annex – the 825 ---- Could I just ask two quick questions? First
19 of all, in Mr. Jones' witness statement he does not actually say what measures of inflation
20 he used to adjust. Can you tell me what he used?

21 MR. VAJDA: I think that is probably best addressed to Mr. Jones when he gives evidence
22 tomorrow, sir.

23 PROFESSOR PICKERING: Can I also say – and I am conscious that you are relying very much
24 upon these figures, and so I assume you have a grasp of what they contain ----

25 MR. VAJDA: The reason I have taken this witness to 825 is because it appears in his witness
26 statement, and I wanted to understand his ----

27 PROFESSOR PICKERING: Yes. Sure. But, you obviously understand why you are questioning
28 him on this. I would also like you to tell me, Mr. Vadja: in relation to the debt that was
29 assumed, that is dated 1957 (if I am reading it correctly) of £161,000, is that actually an
30 expenditure? On what basis has that been adjusted for inflation? Is it using the same
31 figures as Mr. Jones is going to tell us tomorrow? Does it go back to 1957? Do you know
32 the answers?

33 MR. VAJDA: It is not for me, Professor Pickering, to give evidence.

1 PROFESSOR PICKERING: No. But, I am just interested to know what your understanding is in
2 relation to matters you are putting to Dr. Bryan.

3 MR. VAJDA: Those will be dealt with tomorrow.

4 PROFESSOR PICKERING: Thank you.

5 MR. VAJDA: (To the witness): Can we now move on in relation to the costs – what we think
6 the stand-alone costs of Ashgrove would be? Your position at the moment, as I understand
7 it, Dr. Bryan, is that it would be £1.1449 million; is that right? For the treatment works.
8 That is, the forward-looking value. A. That was my view of the value of the asset to
9 Welsh that needed to be reimbursed ---- That needed to be paid for through a return on
10 capital.

11 Q We are looking at what the stand-alone treatment cost is. That is the figure that we should
12 be using. A. In terms of trying to find out what a fair cost-reflected price is.

13 Q Yes. Could I ask you to go to your Notice of Appeal which should be ---- A. I have
14 it.

15 Q Paragraph 119. My mistake. It is Annex 2. Detailed analysis. If you go to p.21 – cost
16 descriptor. You come there to a figure for budget total of £2.6 million. So, that was the
17 figure that you were advancing for the stand-alone cost in the Notice of Appeal. A.
18 Yes.

19 Q Why have you now changed your mind and you now say that the figure should be £1.449
20 million. A. I haven't changed my mind at all. I have simply ---- The item you have
21 just taken us to was our response to the Director's view of what it would cost Albion to
22 build a new plant on a new site. That was the figure we came up with for the reasons that
23 were given in that evidence at the time. The £1.449 is the figure that I believe, on the basis
24 of the evidence provided by Dwr Cymru, best reflects the value of the asset to Dwr Cymru.

25 Q What did you understand when you were doing the stand-alone assessment of cost? Can
26 you tell the Tribunal what you had in mind when you produced that? A. I was trying to
27 get to as objective as possible an analysis of the actual costs incurred by Dwr Cymru in
28 providing the service that we had asked for. This is a component of that.

29 Q In looking at that, is one looking at what it would cost for new build? A. In terms of
30 the component which represents the Ashgrove works, that is the approach I have taken – to
31 try and find an MEA value that is consistent with the MEA values that Dŵr Cymru has for
32 the totality of its treatment works.

33 Q So there is common ground here that we are all seeking to find an MEA for new build?
34 A. Well we must not lose sight of the definition of MEA, in terms of efficiency and to

1 provide the necessary functionality. Let us not lose sight of the fact that the functionality of
2 Ashgrove is marginal at best because there are no quality standards associated with it, but
3 yes.

4 THE PRESIDENT: If I have followed it in this Annex B of the Notice of Appeal, this is under
5 the heading, is it, "Assessment of Economic Viability of Duplication of the Ashgrove
6 System"? A. That is correct, Sir.

7 MR. VAJDA: Yes, and that is really consistent with paras. 2 and 74 of your annex B where you
8 say you agree with Mr. Jones, you are looking at this on a forward looking basis? A. I
9 have not sought consistency between an exercise which challenged the Director's earlier
10 conclusion that the Ashgrove system was not an essential facility. I have not sought
11 consistency with that and later analyses based on completely new and significant evidence
12 that has emerged since that time.

13 Q Do you agree that when one is doing this stand-alone analysis one looks at the lowest cost
14 that would be incurred by the hypothetical supplier supplying this on a stand-alone basis?

15 A. In the specifics of this case, the most effective solution – the least cost, most efficient
16 solution – to the replication of the functionality of the Ashgrove system, given particularly
17 Corus's stated desire as evidenced before this Tribunal that they too wished to receive
18 supplies from Albion, would be to refurbish the existing pipeline and to do away with
19 Ashgrove, because it fulfils no function that could not better be fulfilled at the other end of
20 the pipeline. But I have not chosen that particular route in this evidence because that is
21 going off at a tangent. But that is of course an option when one is considering efficiency ---
22 -

23 Q What I am asking you, Dr. Bryan is what was the option that you chose, do you accept – I
24 will put my question again to which I have not had an answer. Do you accept that one looks
25 at the lowest cost that could be faced by a hypothetical supplier building back on a stand
26 alone basis. Yes or no? A. No, that was not my understanding of what the Tribunal
27 wanted. My understanding was the Tribunal wanted a view of the actual cost incurred by
28 Dŵr Cymru as it is currently constituted with the assets it has, and in this case, assets that
29 were given to it apparently with some transfer of debt in the 80s.

30 Q Well can I ask you to look at Mr. Jones's second witness statement at p.3. Does the
31 Tribunal have that?

32 THE PRESIDENT: Yes.

33 MR. VAJDA: If one goes to footnote 1, if the Tribunal and Dr. Bryan just read footnote 1 to
34 themselves. (After a pause) You will see that that is the way that Chris Jones approached it

1 by reference to the OFT test. I take it from your last answer that is not the way you have
2 approached it, is that correct? A. It is not the way I have approached it.

3 Q You have not looked at the stand-alone cost of activity is the least cost which would be
4 incurred by a hypothetical, efficient ... A. I have taken the view, quite deliberately, that
5 were a water company to base its tariffs on new build, then those tariffs would be
6 exceptionally high compared to the tariffs which are based on largely inherited assets and
7 that any such approach would be inherently discriminatory.

8 Q So what you are saying is you do not accept the relevance of 414 in the water industry. Is
9 that what you are saying? A. I am not qualified, as you have already made clear, to
10 address issues which appear here to be legal issues, and those relating to economic theory,
11 so I am not qualified to answer.

12 Q I just want to be fair to you, so I have understood your evidence on this. I think what you
13 are saying, and please correct me if I have got this wrong, is that so far as stand-alone cost
14 in the water industry is concerned one should not look at a hypothetical efficient
15 comparator, but one should look at the position of the water undertaker and it is relevant,
16 and one should take into account the fact that the water undertaker may have got the assets
17 for very little, is that a fair approach? A. No, it is fair to say that in terms of deriving
18 MEA values, be it for the treatment works and, indeed, for the non-potable mains, I have
19 tried to put myself in the position of Dŵr Cymru, and ask myself what would be the least
20 cost solution to this. In that sense, I would be assuming the same plot of land, the same
21 infrastructure in terms of services, and an MEA value then based on the most efficient way
22 of using what is already there if it had to be replaced.

23 Q I am slightly unclear as to what your answer is. Are you saying one looks at it on the
24 hypothetical comparator, or one does not? A. I am confused as to what you mean by
25 “hypothetical comparator”, but if I can use the ----

26 Q Well I am using the “hypothetical efficient undertaking” – the words that the OFT use – I
27 just want to make sure, because it is obviously very important – the Tribunal is clearly
28 concerned about this, that we are comparing like with like, and indeed as the President has
29 quite rightly said there may have been some confusion on what was meant by the stand-
30 alone analysis, so it is important that we explore this and we understand what your position
31 is. Perhaps you could tell me again because, the fault is no doubt mine, I have not quite
32 captured quite what your position is on this? A. I think the answer to the question you
33 put to me is that the MEA value that I have relied upon is that which I felt comfortable
34 would replace the existing functionality. But, given the fact that it is Welsh Water who will

1 be replacing it, and it is on land they already own, and with additional infrastructure that is
2 already there. The pipeline is a very good example. One cannot thread a new pipe through
3 an old pipeline unless one has the old pipeline. I have assumed those existing assets.

4 Q With respect you are confusing the issue. We are looking here at stand-alone costs ----

5 THE PRESIDENT: Mr. Vajda, I think this is a difficult area ----

6 MR. VAJDA: It is a difficult area ----

7 THE PRESIDENT: In the Tribunal's mind at the moment it is not at all clear that OFT 414 and
8 other remarks in that context, which talk about the need to identify the costs of a separate
9 business are talking about the costs of the business as it is, or the costs as you interpret it –
10 as I have understood it – the costs of a new build on the basis that there is a new build.

11 MR. VAJDA: I fully see that, and I see that as a key point in this case, Sir. But, of course, what
12 is important for all parties is that we understand the methodology that is being adopted.
13 Ultimately, obviously, it is a matter of law as to whether our view or Albion's view is
14 correct, but what I need to understand – and what the Tribunal needs to understand – is what
15 was the methodology that was used here?

16 THE PRESIDENT: Quite.

17 MR. VAJDA: That is what I am exploring.

18 THE PRESIDENT: Yes, well I thought you had got your answer to that, but you go ahead and
19 make sure you did.

20 MR. VAJDA: (To the witness) The answer is you are looking at it simply through the eyes of
21 Welsh Water, and you are not looking at it from the point of view of the hypothetical
22 efficient undertaking? A. I am looking at it solely through the eyes of evidence, well not
23 solely but to an overwhelming degree on the basis of evidence provided by Welsh Water.

24 MR. VAJDA: I think, Sir, I will make my submissions on that. I will move on now to the next
25 topic, which is rate of return.

26 THE PRESIDENT: Yes. Are we still on treatment works?

27 MR. VAJDA: Rate of return does obviously ----

28 THE PRESIDENT: Covers everything.

29 MR. VAJDA: It covers everything, but what I am going to do, with your permission, Sir, is deal
30 with rate of return in relation to treatment. I am not then going to go back to rate of return
31 when we get to the mains.

32 THE PRESIDENT: Yes.

33 MR. VAJDA: (To the witness) We can pick it up, Dr. Bryan, if we go back to your Annex A.

34 THE PRESIDENT: Which is tab 2.

1 MR. VAJDA: Do you have that, Dr. Bryan? A. I do, yes.

2 Q It is para. 213 of Annex A.

3 THE PRESIDENT: The 0.8 per cent. figure.

4 MR. VAJDA: Absolutely. (To the witness) What I would ask you, Dr. Bryan, is could you
5 please explain to the Tribunal why such a figure is appropriate in the present case? A. It
6 is a figure which represents Dŵr Cymru's actual return on its gross MEA value as expressed
7 in its asset register, averaged over a period, I believe I took the average over a period of
8 seven years.

9 Q Yes. A. And those figures are obviously from OFWAT.

10 Q Do those figures there, return on capital, we see the 0.8 per cent., do those figures tell you
11 what you need to earn for new investment in your view? A. No, they clearly do not.

12 Q Now, you accept and we are doing this exercise on a stand-alone basis, so we have to look
13 at everything on a stand-alone basis, do we not? We cannot, as it were, mix and match, you
14 have to look at it all on a stand-alone basis? A. Well I fear that we are on two different
15 tracks there because, as I have tried to make clear, the purpose of this witness statement was
16 to use the evidence that we have now managed to get to understand what the actual costs are
17 that are incurred by Dŵr Cymru and to come up with a figure that is consistent with the way
18 that their other charges are raised. In other words, the return on investment for assets that
19 already exist, as well as some assets which are in the process of construction.

20 Q What we have, and you are challenging that, is obviously figures based on average costs,
21 average prices, but what the Tribunal asked for, and what we are examining now is a cross
22 check, stand-alone – you understand that?

23 THE PRESIDENT: We did not ask for new build, Mr. Vajda – or indeed, we did not think we
24 had asked for new build. You may tell us that is the only thing that is relevant, but it is not
25 what we asked for in our mind.

26 MR. VAJDA: That is obviously something that we will explore, but again, Sir, this is critically
27 important to understand where these figures come from, what the justification is and
28 obviously I have to put it to you, Dr. Bryan, that if one is looking at this on a stand-alone
29 basis we are looking at a non-potable system. Do you agree with that because Ashgrove ----

30 THE PRESIDENT: When you use the phrase “stand-alone” you mean on the basis of a
31 hypothetical new build of this plant. That is what you mean by that expression?

32 MR. VAJDA: It is the OFT test and we are looking at ----

33 THE PRESIDENT: You say it is the OFT test?

1 MR. VAJDA: Yes, yes, absolutely. Obviously, there is an issue between the Authority and Dŵr
2 Cymru on the one hand and Albion on the other as to what the appropriate test is ----

3 THE PRESIDENT: It is just to be sure what we mean when we use certain phrases, that is all I
4 am trying to do.

5 MR. VAJDA: Yes, and indeed you, Sir, will recall that the Authority spends quite a lot of time
6 in its annexes to the skeleton dealing with stand-alone local costs and matters of that sort.

7 THE PRESIDENT: Absolutely.

8 MR. VAJDA: (To the witness) So far as stand-alone is concerned, you accept of course that we
9 have to look forward, do you not – even on your basis? A. Yes.

10 Q We are looking at something for the future. Now, would you accept that looking at a non-
11 potable stand-alone system serving just two commercial customers is more risky, has a
12 higher risk than putting it this way, than the whole of Welsh Water’s business looked at on
13 its own. Perhaps I can just develop that before you answer that question so you can see the
14 point I am making. If you are looking simply at a stand-alone non-potable system that is
15 going, as we know now to Shotton and Corus, when one is looking at that from the point of
16 you forward looking “What is the cost?” That is going to be higher risk because there is a
17 risk of one or other customer shutting down than a system which serves millions of
18 domestic customers across the network. Would you agree with that? A. Yes.

19 Q So would you then agree that that would demand a higher rate of return than Dŵr Cymru
20 gets from its business as a whole, looking at this simply on a stand-alone basis? A. Not if
21 it were undertaken as a regulated activity because in that regard those with revenues would
22 be underwritten effectively by the price-setting mechanism of OFWAT and if they lost a
23 substantial chunk of income that was unforeseen then they could go back at the next
24 periodic review, or if it was really quite urgent, go back in between times and seek an
25 interim determination that would redress the balance in terms of revenues. If you are saying
26 what is the nature of the risk? The primary determination of risk in that sense is whether
27 those activities are regulated and therefore underwritten by the pricing mechanism within
28 OFWAT or whether they are truly commercial and subject not just to the customer shutting
29 up shop, but to the far greater risk, one would hope, of competition and somebody else
30 taking that customer from you.

31 Q If we can just explore that for a moment. You said that if, say, Shotton were to shut down
32 that would be “underwritten”, as you put it, because you have the benefit of regulated
33 prices. Could you just unpack that quite important sentence for us? What do you mean by
34 that? A. Let me give you an example, which is based on reality rather than speculation.

1 Prices are set for water companies on the basis of a forward looking five-year plan every
2 five years, and OFWAT makes certain assumptions which it builds into those prices, and for
3 example, a very pertinent example in the current climate is that it makes assumptions about
4 the number of customers who will switch to meters. Most customers who switch to meters
5 do so because there is a financial benefit in doing so. Typically they use very little water,
6 particularly if they have a high rateable value house. So, there is an assessment at the time
7 that the prices are set that reflects the risk of those customers changing and revenues falling.
8 If the out-turn is that customers switch far more rapidly, then it is open to the undertaker to
9 go back to OFWAT and say, "You've got it wrong. We're short of revenues. Can you
10 please look again at our price limits?" In some cases OFWAT will say, "Yes, you have a
11 justified case", and you can raise your prices.

12 Q Just unpacking that a little bit further, you go back to OFWAT and you say, "We're short of
13 revenue. We want the prices raised". What prices would be raised? A. Well, they
14 would typically be the prices associated with that class of customer – that to the extent that
15 there were other factors ---- It is very difficult. You would have to look at the case on its
16 merits.

17 Q Isn't what you are saying this: that because Dwr Cymru has millions of customers, that for
18 Dwr Cymru this is a low risk because if this project goes, as it were, belly-up, or Shotton
19 shuts, the other customers can bear the risk. Is that what you are saying? A. No. I'm
20 saying that ----

21 Q What is it that you are saying? A. I am saying that prices are based largely on agreed
22 expenditure targets for the companies, and OFWAT has tried very hard over the years to
23 make sure that the water companies raise enough revenues to make those expenditures?

24 A. We're looking at this, at the moment, on a stand-alone - not an average cost – basis. A
25 stand-alone basis.

26 Q So, perhaps I can put it this way: supposing Dwr Cymru goes to Barclays Bank to raise
27 money for this on a stand-alone basis, would you accept that that is going to be higher risk
28 for the bank – and therefore for Dwr Cymru in terms of financing it than in relation to
29 looking at the investment across the board ---- looking at this on a stand-alone basis, this
30 project which is going to serve two industrial customers? A. If it were to do so as a
31 regulated business the risk would be very low. If it were to set up a truly arm's length
32 subsidiary and effectively to take a speculative hike at this, were they, for example, to try
33 and build a similar system for one of their neighbours – United Utilities' customers, then,
34 yes, I grant you, under those circumstances it would be perceived to be a proportionately

1 higher risk. Of course, they are not allowed to do that by virtue of the structure of the
2 company.

3 Q This is where I have some difficulty, and you must help me. You say that because it is a
4 regulated company, there is less risk. How does the fact that Dwr Cymru is a regulated
5 company make it less, or more, likely that Corus or Shotton are going to shut down? A.
6 It doesn't make it less or more likely, although there is a factor associated with the price of
7 water for both those customers which does affect those customers' viability. But, I think
8 that the point you make is that the revenue effect of such a shutdown would be covered in
9 the price –setting mechanism.

10 Q So, Dwr Cymru can fall back on the rest of its business to mitigate the risk. A. That
11 what OFWAT allows it to do.

12 Q I am not interested in what OFWAT does. What I am interested in is your argument as to
13 how you justify the 0.8 percent. I think, you are saying it can be justified on the basis that
14 Dwr Cymru has got a large business, and effectively if this part fails it can go back and re-
15 adjust its tariffs on the rest of its business. A. No. I said a little earlier that I do not
16 believe that 0.8 percent is at all appropriate as a return for new investment. OFWAT
17 believes that the cost of capital for new investment is in the order of, I think, 7.7 percent (I
18 can't remember the precise figure, but it is somewhere in that order). I bow to OFWAT's
19 economists in that regard.

20 Q Perhaps I am now beginning to understand. You are saying that you are not using 0.8
21 percent as a realistic figure for new investment. You accept that it is not a realistic figure for
22 new investment. A. I said that.

23 Q But, you say that new investment is the wrong test. Is that the position? A. Yes.

24 Q I am grateful. I see that. We are still on rate of return, but just moving along to the reply
25 skeleton of Albion, at para. 27 ---- Perhaps if I just ask the Tribunal and Dr. Bryan to read
26 para. 27 to themselves? (Pause whilst read): Regulatory capital value. RCV.

27 THE PRESIDENT: I think we will need a bit of help on this, Mr. Vadja, because there are these
28 two measures floating around.

29 MR. VAJDA: On RCV? The Tribunal may anticipate my next question of this witness. At
30 Annex 2, paras. 29 to 30 the Authority criticises the inference that RCV for the Ashgrove
31 system is one twenty-fourth of the MEA value as calculated by Dwr Cymru. Now, can you
32 please tell us where we find the RCV for the Ashgrove system? A. We don't. It's an
33 inference. (After a pause): If you are asking me where RCV features in the figures of
34 OFWAT or Dwr Cymru, unfortunately it is a single sum.

1 Q You accept there is no RCV for the Ashgrove system. A. I accept that there is no RCV
2 as such.

3 THE PRESIDENT: Am I allowed to ask where the inference comes from, Dr. Bryan? How
4 you have inferred it? A. I think the inference comes from the fact that the return on
5 regulatory capital value, which is the figure that the City takes most account of, is based on
6 a figure that started with the value that the markets put on the water company at
7 privatisation and has been adjusted thereafter according to investment and depreciation, and
8 inflation, and that the price-setting mechanism ---- the return that the company is allowed to
9 make which forms part of that price-setting mechanism is expressed as a return on
10 regulatory capital value.

11 Q Yes. But, how have you got – by inference apparently – from the overall RCV of Dwr
12 Cymru to be able to attribute an RCV to the sub-set of the Ashgrove system? A. Well,
13 what I have had to do, because we can't go any further down the road than a single RCV
14 figure, we have to look for another measure of capital value, and the only other measure
15 which is generally in use, and which is available in terms of the disclosures that we have
16 had before us is modern equivalent asset – MEA value. Now, fortunately for us, OFWAT
17 expresses rates of return ----

18 Q I see. You have done it on the rates ---- A. In terms of both RCV and MEAV. So,
19 there is an implicit relationship, albeit at a high level.

20 Q So, just to be sure that I have understood it – and I am sorry it has taken me time -----

21 MR. VAJDA: This is absolutely critical, sir.

22 THE PRESIDENT: What I infer that you have done – and I want you to correct me, and I want
23 Mr. Vadja to challenge, if necessary – is that you know ---- or you have started with an
24 MEA value for Ashgrove. You have said, “Well, according to the Authority, MEA value
25 bears a certain ratio or proportion to regulatory capital value, and it has varied over time,
26 and it is probably a bit narrower now than it was. If I take that proportion as the right
27 proportion, I can derive an implicit RCV from the MEA value by taking whatever
28 proportion you take”. A. That's correct.

29 MR. VAJDA: I fully accept, sir, that there is this issue of law between Albion and the
30 Authority as to effectively whether you apply 414. But, obviously, what is important is that
31 the Tribunal has, if you like, the factual information on both scenarios. (To the witness):
32 We are now looking at the OFT stand-alone hypothetical efficient undertaking. What rate
33 of return do you think they should be earning on that asset in this situation? A. This is
34 on the new build basis?

1 Q Yes – on the stand-alone, new build basis. A. In that situation the MEA value – at least
2 on Day One – is assumed to be equivalent to the regulatory capital value that would be
3 added to the balance sheet at that day. So, the answer would be 7.7 percent or whatever the
4 allowed return on the RCV was as set by the Director.

5 Q So that I have understood it, and so that the President has understood it, you are saying, that
6 assuming you am right on the 414, the stand-alone basis, that from your experience in this
7 industry you are saying that a return of 7.7 percent on MEA would be sufficient. Is that
8 your answer? A. An undertaker operating part of its regulated business, yes.

9 Q No. No. Perhaps I should put the question again so that there is no misunderstanding. This
10 is in relation now to a hypothetical stand-alone operation, not in a regulated business.
11 What is the rate of return, based on your experience, that you consider such an undertaking
12 should ---- A. The only experience that we have is when we were part of ... in which
13 case the hurdle rate was 20 percent.

14 Q Of course, there is a great difference, you accept, between 0.8 and 20 percent. A. And
15 there is a great difference between Albion Water and Dwr Cymru, yes.

16 Q Just so that I understand it, what you are saying is that if this was being done by a
17 commercial undertaking with a commercial bank, the commercial undertaking would
18 require 20 percent ---- A. No, I am not saying that. I am saying that a very small
19 company ... with effectively no balance sheet strength is required to hit a hurdle rate of 20
20 percent, if it can get financing on that. A regulated water company, undertaking regulatory
21 business, would get a return based on OFWAT’s return on regulatory capital value which
22 fluctuates between 5 and 7 percent. If it is any other sort of company operating outside the
23 regulatory umbrella, that is a matter for the bankers, but I wouldn’t be surprised at a range
24 of figures between 6 percent and 15 or 20 percent.

25 Q So, I can take it between 6 and 15 to 20 percent is your answer if it is stand-alone ---- A.
26 I certainly accept that new build construction for the water companies needs to earn a
27 minimum of 6 percent for it to be worthwhile under the current economic conditions.

28 Q Subject to your point about the fact that Dwr Cymru is regulated, and therefore you say that
29 ameliorates the risk, is there any other point that you have to say that this is not high risk? I
30 put the point to you that this is high risk because you are doing a non-potable system for
31 two customers. Your answer to that, as I understand it is that, “Well, there can be [if I can
32 put it like this] a cross-subsidy from the rest of the business”. But, leaving that aside, is
33 there any other factor that would point to this being low risk? A. You are leaving quite
34 a lot aside if you don’t take account of the fact that the water industry --- the water

1 companies' revenues are treated by OFWAT as a whole every five years. That is a pretty
2 good safeguard.

3 Q So that I understand, what you are saying is that so far as the water companies are
4 concerned, if they run two businesses – one which is risky and one which is not risky (if I
5 can put it like that, simplifying) – you are saying that I should then set my prices to generate
6 the same return on capital on each. Is that what you are saying? A. No, not at all. No.
7 No.

8 Q What are you saying? A. Dwr Cymru is a very good example. Following privatisation
9 they expanded into all sorts of areas, and what we have today in terms of the Glas Cymru
10 structure with Dwr Cymru was a water undertaker rescued from the ashes of a lot of failed
11 commercial ventures, but those were failures that were ultimately picked up by
12 shareholders, creditors, whatever. In the case of a regulated water undertaker, those risks
13 are actually offset to a hugely significant extent by the regulatory structure in which it
14 words. OFWAT's strong adherence to the view that water undertakers must be able to
15 finance their function. I think what you are saying is that Dwr Cymru should be entitled to
16 the same rate of return, and no more, if you look at this on a stand-alone business than on
17 the rest of its business. That is your position, is it not? A. If it's a regulated business,
18 yes.

19 Q Can we then move on, sir, to distribution costs? Again, what I am going to concentrate on
20 first, in the sense that it follows on from what we have been looking at, is stand-alone.
21 Again, if we can take this up in your last witness statement and go to Annex B, at para. 84
22 you do a table on the basis of the 2004 costs base. A. Yes.

23 Q We are now looking at the pipeline. We have left the treatment works to one side. A.
24 We have yes.

25 Q Your conclusion is between 1.6 and 3 million. I think what you are saying is that it should
26 be at 1.6 because that is at 2004 prices. Have I understood your evidence correctly there?
27 A. I am giving you two figures because there clearly is a different price base. 1.6 is the
28 more efficient figure.

29 Q That is the figure I think that your counsel relies on in his skeleton.

30 THE PRESIDENT: I have understood the difference to reflect the falling costs of pipe laying
31 between the two dates.

32 MR. VAJDA: We are focusing. Again, if we go back to para. 74, which we looked at in the
33 context of treatment, you accept – can I just give the President a note, you are absolutely
34 right what you said about 2000, it is para.56 of Albion's skeleton.

1 THE PRESIDENT: Thank you, yes.

2 MR. VAJDA: (To the witness) You accept again that we have to look at this on a forward
3 looking basis for pipes as well as treatment works, do we not? A. Yes, I am looking in
4 this particular case at the cost of replicating the required functionality.

5 Q Replication is the key, is it not? A. Well, it is, yes. What would it cost Dŵr Cymru to
6 recreate that same functionality.

7 Q Yes. Now, can we just look at para.80 for a moment, just on the bottom of that page, and
8 again if I could just ask the Tribunal and you Dr. Bryan, just to read para.80 to yourself?

9 A. (After a pause) Yes.

10 Q Now, forgive me, but it seems that para.80 you are now moving from replication to
11 remediation, and would you agree that replication and remediation are different concepts?

12 A. No.

13 Q You would not agree? A. No, because in the sense that it is used in the industry, the
14 question that one asks oneself is “Is this the replacement of an asset for an existing
15 purpose?” or “Is it a new asset for a new purpose?” Those are fundamental differences.
16 Are we building because we have new customers, or are we simply replacing an asset that
17 has been worn out? The attitude that I have taken here is that the appropriate way of
18 defining MEA value for existing customers provided with an existing service is to say what
19 would we do if we came to the conclusion the existing asset was worn out? How much
20 would it cost us to replace it? You may call that “remediation” but those are subtle
21 differences. You are actually talking about a new pipe. It is just that you happen to be using
22 the hole that has been created by the old pipe.

23 Q Can I just follow this, because this again is quite important? If I acquired a car for £20,000,
24 and that car needed no remediation, what would the MEA value of that car be on your
25 approach at para.80? A. It could be very little, it depended what functionality you needed
26 the car for. If you were simply using it to park on your drive – you are trying to use
27 analogies to help and I am not sure how helpful they are, but in order to give an answer
28 using the MEA definitions I would first need to know what functionality you required from
29 your car, because then I would be required to provide that functionality for the most
30 efficient cost. That may not be a Lamborghini, it may be a second hand Ford Escort.

31 Q I think you are moving a little bit away from my question. Can I just remind you – perhaps
32 we can go to para.2 of Annex B, which is a passage I have taken you to already where you
33 accept the approach of Mr. Jones to the definition of “MEA”.

1 “Strictly, the MEA value of an asset or system is the minimum that it would cost
2 the undertaker to replicate the required operating capability of an asset or system
3 ...”

4 A. Correct.

5 Q So I come back to my car. I buy the car for £20,000, it is brand new, its gearbox is working.
6 It does not need any remediation, what do you say the MEA value of that car is? Is it
7 nought, or is it £20,000? A. Well if one assumes that that is the only car that will provide
8 you with that functionality and that is the most efficient price for that functionality then
9 £20,000 is the answer.

10 Q Thank you. Now, as I understand it in this part of your case, you are making the same point
11 as you made in relation to the treatment works, that it is relevant to the MEA value at what
12 price Dŵr Cymru acquired it in the past. Are you saying that is relevant or irrelevant? A.
13 No, I am saying it is irrelevant. The fact that they have it is relevant, because one clearly
14 cannot use pipe insertion techniques as the most efficient form of replication unless one has
15 an old pipe in which to insert the new pipe.

16 Q But you accept that it is completely irrelevant at what price they acquire the asset ... given
17 the asset, that is irrelevant to calculating the MEA on a forward looking basis? A. I have
18 not used it in this context, that is true, yes.

19 Q Can I just take you to para.25 of the Albion Reply skeleton. Again if I could ask the
20 Tribunal and you Dr. Bryan, just to read to yourselves para.25 of the skeleton? A. (After
21 a pause): Yes.

22 Q Dr. Bryan, the question I want to ask you relates to the second sentence of para.25. It is said
23 there “Given the facts a more apt analogy would be to a new system worth £9 million, but
24 given to Dŵr Cymru for £0.5 million.” I took it from your last answer that the price at
25 which Dŵr Cymru received it was irrelevant? A. I am sorry, I have some difficulty in
26 tracking back to the arguments that gave rise to this response. I think it is true to say that I
27 do not believe that I have ascribed a zero value to any of the assets – quite the reverse, I
28 have ascribed a value of £1.449 million to the treatment plant, and a range of figures
29 between £1.6 and £3 million to the main. I am not quite sure where the zero value comes
30 from.

31 Q Put it this way, do you agree with me that we can strike a line through that sentence and the
32 skeleton argument. A. I think that the point that counsel was making there, and it may
33 be a point that is slightly at a tangent to the point you wish to draw from it is that on

1 privatisation assets with a value, an MEA of £9 million would actually have been ascribed
2 a value in regulatory capital value terms of half a million.

3 Q Yes. A. There was a 20-fold difference between the replacement costs and the actual
4 valuation that the market put on all companies at privatisation, not specifically on Dŵr
5 Cymru but the others were very similar.

6 Q Just to explore this a little bit further, because it is very important again that we unpack this
7 point, if we take the example of your counsel there, what do you say the MEA value there
8 would be? Would it be £9 million or £0.5 million? A. What we are saying there is that
9 the £9 million is approximately for MEA.

10 Q So you are saying that the analogy that is being drawn here is completely inapt, it does not
11 matter in looking at what the MEA value is, what it was given to Dŵr Cymru for? A. It
12 does matter if the MEA value is presented is of questionable validity, but I am not sure
13 whether that is the point you are trying to make.

14 Q Let me put it slightly differently so I hope you can understand the point I make. Supposing
15 that my grandmother left me an office block in her Will – all right? I spent half a million
16 pounds doing it up, refurbishing it, and it was now worth £9 million. What would its MEA
17 value be? Would it be £0.5 million or £9 million?

18 THE PRESIDENT: That example assumes it was worth £0.5 million in your grandmother's Will,
19 does it?

20 MR. VAJDA: No, I got it for nothing and I spent £0.5 million. It does not terribly matter to the
21 example, but supposing ---- A. I expect it does matter, because as we all know the actual
22 build cost – if a house burns down the cost to build it is significantly lower than the cost to
23 buy a new one on a new plot of land, and I am not sure how useful these analogies are, or
24 how accurate the analogies are to the case in hand.

25 Q You see it is quite important here, Dr. Bryan, because the case that is being put by you and
26 your counsel, and this is the case that I have to deal with ---- A. Indeed.

27 Q -- and I have to tackle you with, is that it is somehow relevant to the MEA that this asset
28 was either given or transferred to Dŵr Cymru in the 1980s at a low figure? A. I have not
29 said that it is relevant to the MEA. I have said, and I believe that if a water undertaker
30 acquires assets at very low cost, as was the price on privatisation, that it is only right that
31 that is reflected in charges which have as their basis the recovery of those costs.

32 Q Yes, I see this comes back to the point, and we did make it earlier, that this has been a
33 useful exchange to understand where you are coming from, what you are saying is that

1 coming back to the water industry it is relevant – you are saying it is relevant to the MEA to
2 look backwards at what the assets were transferred at. Is that your case? A. No.

3 Q No. A. In looking at MEA I have, as I hope my witness statement makes clear, looked at
4 what I consider to be the most efficient cost ----

5 Q -- of replication? A. – of replicating that asset if the existing asset becomes unfit for use.
6 But using what one can of the existing asset if that allows one to replicate as efficiently as
7 possible, and hence the pipe-in-pipe solution that I have proposed for the ----

8 Q I do not understand that. Leaving aside the legal issue, if the OFT test is correct – and I
9 know you do not accept that – the OFT test talks about replication not remedy. Replication
10 means reproducing it? A. I am sorry, but I am not qualified to speak of what was in the
11 OFT’s mind on that, or indeed, how that has been applied. What I would say to you though,
12 which I think is helpful, and it is in the witness statement, is that when one looks at Dŵr
13 Cymru’s forward business plan, a very significant proportion of its new mains are in fact
14 created using these or related techniques. There is a risk in these proceedings of becoming
15 more and more abstract, and forgive me if I try and bring it back to my experience of the
16 water industry of 35 years, to say it is a fact of life that OFWAT requires water companies
17 to be as efficient as possible in spending their customers’ money, and that necessarily means
18 that new techniques and pipe-in-pipe insertion is relatively new. Those new techniques are
19 required, wherever it is feasible and wherever it returns a better and more efficient solution
20 for the customer. That is the basis on which I assess these costs.

21 Q So coming back to the second sentence of the Albion reply, I think you are saying, and
22 correct me if I am wrong, obviously this is important evidence here – we all need to know
23 where we stand – I am not looking now at housing or office blocks, I am looking at mains,
24 that if in fact the mains were given to Dŵr Cymru at £0.5 million, you are not saying that
25 the MEA is £0.5 million, is that right? A. That is not the basis on which you have
26 calculated the MEA, no.

27 THE PRESIDENT: Mr. Vajda, I am not hurrying you in the least, take your time, if we are not in
28 some close distance of finishing we might take a break at quarter to four or at some
29 convenient moment just for five minutes.

30 MR. VAJDA: Well then perhaps now ----

31 THE PRESIDENT: Is that as good a moment as any?

32 MR. VAJDA: Yes.

33 THE PRESIDENT: Right.

34 MR. VAJDA: In terms of forward planning ----

1 THE PRESIDENT: How are you getting on?
2 MR. VAJDA: I am getting on, but I am getting on a little more slowly ----
3 THE PRESIDENT: That is all right, you take your time.
4 MR. VAJDA: This is important stuff, and I hope ----
5 THE PRESIDENT: On the understanding, as always, that you will do your best to move it along
6 then you take your time.
7 MR. VAJDA: Yes, I am grateful.
8 (Short break)
9 MR. VAJDA: Dr. Bryan, can I ask you to go back to Albion's skeleton for this hearing. Just so
10 that the Tribunal are aware, we are still dealing here with the capital cost of the pipes. That
11 is the topic, as it were. We are looking at the capital value aspect of the pipes. What I
12 would like to ask you to do – and the Tribunal as well – is to read to yourself para. 53 and
13 the first sentence of para. 54. This is the main skeleton. (Pause whilst read): Do you, Dr.
14 Bryan, still take the view that the capital value figures of Mr. Jones – that is 9.4 for the ...
15 we have already dealt with treatment ---- Do you still take the view that those are obviously
16 much too high? A. Yes.
17 Q Can I take you back to your own Notice of Appeal? Can I ask you to go to Annex 2, which
18 is, as it were, your detailed analysis? It is your commentary on p.116 of the Director's
19 decision. There, you put, as I understand it, the capital cost of the pipes at 6.7 million, did
20 you not? A. Yes.
21 Q This is, of course, compared to the figure of 3.2 million that Mr. Jones puts forward for the
22 pipes, is it not, that we have just looked at? A. Nine.
23 Q Nine. I beg your pardon. Yes. I apologise. Can I ask you to look at your reply at p. 52,
24 para. 170 – it is the bit that you did, which is effectively your detailed commentary, as it
25 were. I think there you put the figure for the capital cost of the pipeline at 9.7 million, do
26 you not? A. I'm saying there that the Director had the Bechtel report, following a
27 Section 26 Notice issued to United Utilities, I believe. He appeared to ignore the fact that
28 the Bechtel final figure was 9.7 million. So, it is not my figure.
29 Q Yes. But, what you are saying here is that the true cost of ---- the capital cost of the pipeline
30 is 9.7 million. What you are saying is that the Director actually got it wrong because he
31 failed to take account of the Bechtel analysis ---- the estimate. A. Yes. The Bechtel
32 analysis was based on a new pipeline, pumping station, storage, and various other elements,
33 and came to 9.7 million. I am not qualified to say whether it was true, or not. I suspect on
34 would need to build the thing to find that out.

1 Q Why is it that the figure that Mr. Jones has, which is 9 million odd for the pipes, when you
2 have a figure here of 9.7 million ---- why is that obviously much too high? A. Because
3 the cost to Dwr Cymru of replicating that asset using the definition of MEA and doing it in
4 the most efficient way would cost between 1.6 and 3 million as I have evidenced in my
5 witness statement.

6 Q Just remind us how this works in relation to pipes. You agree that MEA is a forward-
7 looking cost. A. Yes.

8 Q Forward-looking. What we need to do is see what it would cost to build 15km or so of
9 pipes over the new route. That is what an MEA is designed to do, is it not? A. No. It
10 is designed to replicate the existing functionality. How one does that depends on the
11 circumstances, and what I am saying is that the most efficient way of doing that – which is
12 what I understand to be the basis for an MEA value – would be for Dwr Cymru to use the
13 existing pipe as a conduit for a new pipeline which is inserted within it.

14 Q That is your remedy point, is it not – your remediation point? Obviously there is an issue
15 of law here that the Tribunal will have to sort out, but your evidence effectively is that the
16 difference between the 9.7 and your 1.6 is because you can actually insert a pipe into the
17 existing pipes. A. There are two elements to it. The first is that I ask myself, “If I
18 were in Dwr Cymru’s position, what would I consider to be the replacement costs for that
19 asset – the Ashgrove pipeline?” I am including in that the short length between
20 Heronbridge and Ashgrove water treatment works, for the avoidance of doubt. What is the
21 most efficient way of doing that? I come up with the answer of 1.6 to 3 million, based on
22 the two different costs bases between 1999 and 2004. But, I do not leave it at that. I then
23 go on to apply similar methodologies in terms of the use of MEA ---- the MEA cost base
24 figure to look at the totality of Dwr Cymru’s raw water aqueducts which we now know
25 includes non-potable mains as well as those dedicated to providing water to treatment
26 plants. The total that I come up with using my methodology is very close indeed to the
27 total value that Dwr Cymru put in their 2004 asset register for that class of asset. So, I take
28 that as an indication that I am probably on the right track. If I tried to substitute Mr. Jones’
29 value in that, it of course throws out that total valuation quite alarmingly.

30 Q Let us just unpack this, shall we, Dr. Bryan? You give two reasons, as I understand it, for
31 the 1.6 million. One is that it is remediation, and I have explored that, and we have seen
32 that in your evidence, and obviously that is a matter that the Tribunal will have to form a
33 judgment on. The second I am afraid I have not seen in evidence. This is how you get to
34 the 1.6 million by looking at the raw water aqueducts. Can you point us, and the Tribunal,

1 to where you have done that to get to the calculation of 1.6 million? A. Yes, indeed, I
2 can. I would refer you to Annex B of the witness statement which talks about capital value.
3 That is a fairly lengthy and detailed section, as you will appreciate. But, what it does is ----

4 THE PRESIDENT: Is this paras. 85 onwards? A. It is actually p.52, para. 1 onwards in
5 terms of my approach. I then look at the importance of unit costs, which is paras.8 to 12.
6 Because the evidence from Mr. Jones is that unit costs form the basis of MEA valuations ---
7 - Well, we know what the MEA values are in the asset register. So, I then examine those
8 MEA asset values. I examine the unit costs on which they are apparently based. I
9 demonstrate that I have significant problems with the unit costs that Dwr Cymru uses in
10 1999.

11 MR. VAJDA: Just help me: which paragraphs in Annex B ---- I am sorry to unpack this, but
12 you talk about the MEA values in the register. Are you talking about CCV here or MEA?

13 A. MEA. The asset register is an MEA value.

14 Q Are you saying there is an individual ---- We are looking at stand-alone at the moment, are
15 we not? A. You are asking me for the approach that I took. Unlike water treatment
16 works, we have a breakdown of MEA values disclosed by Dwr Cymru for different sizes of
17 mains. We have disclosure of the unit costs of mains laying for different sizes of costs –
18 both unit costs that have been submitted in evidence by Mr. Jones and OFWAT’s
19 benchmark unit costs which are based on their analysis of unit costs across the industry. I
20 go into that in some length in that statement.

21 Q As I understand it, your evidence on the valuation of the mains begins at para. 72 on p.69
22 where you set down the table which ends up with the estimate by Chris Jones. Do you see
23 that? A. Yes, I see that.

24 Q 9.3. Then you say at para. .74, “I accept Mr. Jones’ definition of MEA values ... to
25 replicate”. So, it is the replication test. Now, where is it at paras. 75 to 84 that one finds
26 the analysis by reference to raw water aqueducts that you were telling the Tribunal about a
27 moment ago? A. Although there is a very real risk that I am confused, I suspect that
28 you are. The unit costs that I use in these calculations do not distinguish ---- The unit costs
29 which appear, for example, in para. 82, in the table there – those unit costs are not based on
30 raw water; they are not based on potable; they are not based on non-potable. They are
31 based on mains laying, the presumption being that to put a single length of pipe in the
32 ground is the same for given ground conditions irrespective of what water is going through
33 it.

1 Q So, just to understand, you are saying that the unit costs for laying a pipe, whether it is raw
2 water, non-potable, potable are the same. A. The unit cost for laying a length of pipe.

3 Q Okay. That is fine. I interrupted you. Please, go on. A. So, if you are looking for a
4 figure in here which relates specifically to the unit costs of raw water mains, you will not
5 find it because those unit costs apply to any type of main and are determined by the
6 diameter of that main and the ground through which it passes.

7 THE PRESIDENT: Can I just ask you to turn on through this difficult – and I know it is
8 difficult to follow all this – at para. 85 we have non-potable mains, MEA valuation, and
9 then over the page we have raw water aqueduct MEA valuation. A. Yes, indeed.
10 What I am doing is I am using the same methodology.

11 Q To take this discussion back to where it started a few minutes ago, I understood you to be
12 saying that you had done some sort of cross-check with raw water aqueduct MEAs, and I
13 had perhaps wrongly assumed that that is what you started to discuss at para. 89 onwards.
14 A. I have done that cross-check, and the results of that cross-check you will see in para.90
15 on p.73 where what I have done at that stage is calculated a value for the MEA of non-
16 potable mains using the same methodology ---- That is the generality of non-potable mains
17 which you see in para. 87. ‘Refer to the table above.’ Using the same methodology that I
18 have used for Ashgrove, sir, I have tried to be absolutely consistent in terms of the
19 benchmark costs I have used. I have then used the same methodology to calculate the MEA
20 value for what remains of the raw water aqueducts – i.e. the raw water aqueducts that are
21 not non-potable mains. As you will see in para. 90, if one adds 82.7 million to 18.324
22 million, we end up with a figure of 101 million. The entry in Dwr Cymru’s asset register is
23 102 million. That is a less than 1 percent difference. I consider that to be pretty significant.

24 MR. VAJDA: I am sure the fault is mine. But, how does that feed into the figure of 1.6
25 million that you reached at the table ---- A. It does not feed into it. It is merely a
26 check. In reaching the figure of 1.6, using a methodology that says, “Understand how you
27 are going to replicate this facility and then work out the cost of so doing using OFWAT
28 benchmark figures ----“ Rather than leave it at that point, what I then did is to say, “Well, let
29 us have a cross-check. Let us use that same approach – those same OFWAT benchmark
30 figures, and let us apply that methodology to the remainder of the non-potable stock, and to
31 all the raw water aqueducts”. The conclusion is that my methodology gives me an answer
32 for total MEA of 101 million and DWR Cymru’s total for MEA is 102 million. I believe
33 that that is significantly close.

1 Q I think you said that so far as Ashgrove was concerned, you did a pipe insertion. A.

2 Indeed.

3 Q For the other pipes did you do pipe insertion? A. I couldn't because I didn't have the

4 necessary information to determine functionality.

5 Q So, you were not comparing like with like. A. Arguably, but, in point of fact, the pipe

6 insertion costs and the rural pipelaying costs are rather close. So, the scale of difference, if

7 one were to apply different technologies, is not huge. There are specific circumstances

8 with Shotton which dictate that pipe and pipe is by far the best method.

9 Q Yes. It is just that it is a little confusing because you say at para. 89, "I applied the same

10 technique to a valuation of the remaining raw water aqueducts". The fault may have been

11 mine, but I had assumed that you were doing it on a like-for-like basis. But, you are

12 actually not doing it on a like-for-like basis. A. I am doing it on a like-for-like basis

13 and I am using the OFWAT benchmarks. But, I do not have the functionality details to be

14 able to say that I could downsize those mains from 700 to 600 millimetres and retain the

15 necessary functionality.

16 Q How does laying the pipe inside a pipe explain the difference between 1.6 and 9 million?

17 A. Well, you will see from the evidence – and I hope that that evidence has been made

18 clear here – that if you are building a new pipeline (and we are talking about a greenfield

19 site), the first thing you have got to do is find a passage of land between Heronbridge and ...

20 a distance of some fifteen to sixteen kilometres, over an area which has had heavy

21 development since the 1950s when the first pipeline was put in. That is the first point. So,

22 you have got to find that land. Now, the first pipeline was subject to, I think, twenty-four or

23 so easements and wayleaves. So, first of all, one would have the cost of finding the route,

24 which is likely to be longer, and of getting consent from the landlords – easements for rights

25 over that land. What one then needs to do is excavate because with a new pipe in virgin

26 territory you have no choice. You have to dig holes, and you have to dig a pretty big hole to

27 put a 600 millimetre pipe through. So, you have to do that.

28 You have huge complications in terms of river crossing. Then, as you approach Shotton

29 you have even bigger complications because the sites through which you would have to

30 pass were formally coking works associated with the old steel mills. Coking works – as

31 anyone who has dealt with contaminated land will tell you – are full of tars, and phenyls,

32 and we know all about phenyls on the River Dee. Those are real problem areas. What it

33 means, in effect, is that when you dig a hole, the stuff you take out is notifiable waste, and

34 has to be disposed - in some cases incinerated. It is extremely costly and difficult job.

1 Those all add to cost You cannot put a plastic pipe through that sort of terrain because
2 certain plastics – phenyls in particular – will go through plastic pipes. So, you can start to
3 see some essence of why it was that Bechtel, who are far more competent in these areas
4 than I am, came to the conclusion that 9 million/9.7 million was an appropriate cost for the
5 pipeline, plus a number of ancillaries.

6 However, if you are putting a pipe within a pipe the beauty of that is that although you do
7 need to create pits occasionally – because clearly you have got to feed the pipe in and you
8 have got to be able to pull it through – it is actually a non-invasive technique, and when you
9 come to the area, for example, near Shotton, which I have spoken about, with contaminated
10 land, you are actually using the barrier created by the existing pipe as protection. You need
11 no excavation in those contaminated areas at all.

12 Q The difficulty I had was this: I think you said that pipe in pipe – which is, if you like, the
13 insertion technique, if I can call it that – is roughly the same cost as new build in a rural
14 location. Was that right? A. Broadly speaking, yes.

15 Q Now, we know that the figure for new build in a rural location is 9 million. A. No, we
16 don't. We know that the cost that Jones ascribes to it is 9 million. We know the cost that
17 Bechtel ascribes to that, plus other things, is 9 million. It is not all rural. I mean, Welsh
18 Water's evidence is that I think, 25 percent (it may be more) of the pipeline is actually
19 urban. I dispute that.

20 Q I am just trying to work on your evidence that you have given to the Tribunal a moment
21 ago. You are saying that the two are the same? A. No, I am not. What I am saying is that
22 when OFWAT create these benchmarks, it is very explicit that the benchmarks represent
23 uncomplicated conditions. So, yes, if by "rural" you mean a nice stretch of virgin pasture
24 you are right. If by "rural" you mean land that was previously a coking works, may have
25 grass on it now, but is contaminated, or if you mean by "rural" that it has to cross a river,
26 then those benchmarks fall down as OFWAT itself recognises. They do not, however, fall
27 down with pipe-in-pipe techniques, because those are not affected. If you are pushing a pipe
28 through a pipe it really does not matter if that pipe is going under a river.

29 Q I am puzzled, because if we go back to your insertion basis, you are saying that that is 1.6
30 million? A. On the 2004 cost base, yes.

31 Q 2004 cost basis. New build, we have seen, you are relying on the Bechtell report 9 million,
32 how does one account for this vast difference between 1.6 and 9 million? A. No, I have
33 not relied on the Bechtell report, I have simply identified that the Director had the Bechtell

1 report with 9.7 million when he came up with a much lower cost in support of his argument
2 that the Ashgrove system was not an essential facility.

3 MR. VAJDA: This might be a convenient moment, Sir. I can give an indication as to where I am
4 at.

5 THE PRESIDENT: Yes.

6 MR. VAJDA: I have pretty well finished on capital value. Rate of return I have essentially dealt
7 with already in relation to treatment works, but it is the same basic point.

8 THE PRESIDENT: Yes, well there is a lot of argument as well in the – so I think we are in a
9 position ----

10 MR. VAJDA: Exactly, that is effectively stand-alone. I then propose to go on to deal with some
11 points on the average costs' basis which we have not yet explored, which is the cost drivers,
12 the difference between potable and non-potable pipes, which is ----

13 THE PRESIDENT: So we have more or less done ----

14 MR. VAJDA: We have more or less done stand-alone.

15 THE PRESIDENT: Whatever we mean by that.

16 MR. VAJDA: Yes.

17 THE PRESIDENT: We have still got to do potable and non-potable.

18 MR. VAJDA: What we have to do effectively, I suppose in terms of methodologies it is
19 methodologies 2, 3, 5, 6 and 8, which is effectively everything other than stand-alone, but
20 the essential points are the costs drivers.

21 THE PRESIDENT: Yes. How long do we anticipate the Director is likely to be with Mr. Jeffery?

22 MISS SLOANE: I am afraid I am not in a position to say because Mr. Anderson has prepared
23 that cross-examination, but certainly from my preliminary talks with him I understood it
24 would not be particularly long, perhaps half an hour at the most.

25 THE PRESIDENT: We would like to aim to get through the Albion evidence by lunch time
26 tomorrow, Mr. Vajda, does that sound unreasonable to you?

27 MR. VAJDA: No, it does not. I will do my best to assist. I was thinking myself probably about
28 another half an hour, then there will be some re-examination. I am obviously going as
29 quickly as possible.

30 THE PRESIDENT: Absolutely, you have the time you want but let us see if we can move on as
31 convenient.

32 MR. VAJDA: That is very helpful, I have been given a benchmark, not an OFWAT benchmark,
33 but a benchmark by this Tribunal on 2006 standards and I will try and see if I can meet that
34 and not be excessive or squeeze.

1 THE PRESIDENT: We will do our best to honour that mark. Right, we will say 10.30
2 tomorrow? Overnight rules, Mr. Thompson, Dr. Bryan is still under cross-examination. Do
3 you need to consult him overnight?
4 MR. THOMPSON: No, I think that will be fine, or at least we will endure.
5 THE PRESIDENT: Just follow the same rules overnight, if you would be so kind, and just go
6 home.
7 MR. O'REILLY: Sir, just before the Tribunal leaves Dr. Marshall indicated earlier today that she
8 might find it convenient to put in a note on postal services. Is the Tribunal is minded to
9 receive that – I do not know whether you have had an opportunity to think about that.
10 THE PRESIDENT: I suspect we have not had much of an opportunity, but I am inclined to think
11 that a note on postal services is not going to take matters very much further, but can we
12 come back to you on that tomorrow morning?
13 MR. VAJDA: Again, in a sense what is sauce for the goose is sauce for the gander, it is going to
14 mean that there is going to have to be reply evidence.
15 THE PRESIDENT: We will come back to that tomorrow morning. Very well, Dr. Bryan, you go
16 home tonight and we will resume tomorrow.
17 (Adjourned until 10.30 a.m. on Wednesday, 31st May 2006)