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

Case No. 1046/2/4/04

Victoria House,  
Bloomsbury Place,  
London WC1A 2EB

31st 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

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**HEARING DAY TWO**

## 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.

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

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

Mr. Fergus Randolph (instructed by the Group Legal Manager, United Utilities) appeared on behalf of United Utilities.

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1 THE PRESIDENT: Good morning, Mr. Vajda. Mr. Anderson, we are pleased to see you.  
2 MR. ANDERSON: I am very pleased to be here.  
3 THE PRESIDENT: If you need to ask for our latitude at any moment, please do so.  
4 MR. ANDERSON: That is very kind of you, Sir.  
5 THE PRESIDENT: Mr. Vajda, can I just mention a couple of things, one on the housekeeping  
6 front. I think we are quite anxious if we are able to, to get through the expert evidence, or at  
7 least as much of it as we can by the end of tomorrow, because we are not sitting on Friday  
8 and they are long days for the experts while we trudge through quite complicated stuff that  
9 does not directly necessarily affect them, so if we could build that into our timetable that  
10 would be very kind.  
11 The other matter really is a request for information, which I think we have probably got in  
12 our papers, or could work it out, but it is much better that the parties do it and perhaps agree  
13 it. We are particularly anxious to understand the whole company cost accounting approach  
14 on which you are relying, and the whole system of price determination in this industry and,  
15 in particular how the price determination mechanism affects the prices to industrial  
16 customers. It might be convenient that the best way of doing that is for us to actually see  
17 the price determinations that were made in 1999 and 2004 if those are the right years, so that  
18 we can understand how it works, but that is what we need to understand. That is the first  
19 and, I hope, relatively straightforward point.  
20 The second point, which again I think arises or came to mind in the course of cross-  
21 examination yesterday, is this difficult question of MEA values and regulatory capital value  
22 and rates of return and so forth. I think what would be very helpful to us, and we probably  
23 could pull it out of the papers we have got, would be the following: if we could have a little  
24 piece of paper that is set out respectively for MEA values and regulatory capital values  
25 over, say, a recent five year period, the rates of return that we in fact earned on those figures  
26 respectively, that will give us an average profit figure on that capital. If we then take – I am  
27 not quite sure whether it is water input, or water delivered, it is probably best to do it on  
28 both bases, we can see what the return is across that period in terms of pence per m<sup>3</sup> and  
29 that would be quite an interesting figure as a background figure looking at it on a whole  
30 company basis – I think we are talking about water services, I do not think we are talking  
31 about sewerage, but you may tell me we are, but I am assuming we are talking about water  
32 – and that would be some background information that we might find helpful or  
33 informative, or not as the case may be, but it is some background information which I  
34 would be quite glad to have pulled together if that is possible.

1 MR. VAJDA: Can I just clarify, in your last question, I assume the President is referring to  
2 Welsh Water or the industry as a whole?

3 THE PRESIDENT: Welsh Water, yes.

4 MR. VAJDA: If I can make an observation, I am sure the Tribunal has this well in mind,  
5 obviously when one is looking at rates of return on a stand-alone basis that is, of course, a  
6 very different rate of return ----

7 THE PRESIDENT: Absolutely, yes.

8 MR. VAJDA: With your permission, Sir, if I can resume.

9 THE PRESIDENT: Yes, I am sorry to ----

10 MR. VAJDA: Not at all.

11 Dr. JEREMY BRYAN, Recalled

12 Cross-examination by Mr. VAJDA (continued)

13 Q Could I ask you, Dr. Bryan, to take up Annex B to your fourth witness statement that we  
14 were looking at yesterday?

15 THE PRESIDENT: Are we on to potable/non-potable now?

16 MR. VAJDA: No, there are just one or two small points I just need to clarify in my own mind in  
17 relation to the evidence right at the end of yesterday and then we are going to move on to  
18 potable/non-potable. (To the witness) You know we finished yesterday looking at your  
19 figure of 1.6 million? A. Yes.

20 Q And I was comparing that with the 9.7 that Mr. Jones had, and the 9.7 of Bechtell, do you  
21 remember? A. Yes.

22 Q Just so I understood your evidence, I think you made three points. Your first point was that  
23 your method of doing a stand-alone calculation was a mixture of doing pipe-in-pipe  
24 insertion, plus laying pipe in virgin rural territory. Is that right? A. It was, in my view,  
25 the most efficient and economic way of replicating the desired functionality.

26 Q So what you did in your stand-alone is to use for some length pipe-in-pipe, and if we just  
27 look at that at the table at 82. You use pipe-in-pipe for, roughly speaking, say, around 4  
28 kms, particularly for the bit in the urban areas is that right? A. That's true.

29 Q And the rest you use on the basis of laying it in rural areas? A. Correct.

30 Q Yes. So that is the first point. The second point I think you made to me yesterday – made  
31 to the Tribunal – is that the pipe-in-pipe cost is the same as the cost of laying a pipe in a  
32 rural location? A. They are not identical. They do vary, they vary with time.

1 Q You said yesterday they were the same? A. They are broadly similar and certainly a lot  
2 cheaper than the alternative. Where I have used pipe-in-pipe I have used it because the  
3 alternative would be hugely costly, and very difficult simply in terms of engineering.

4 Q Yes, what we can see, if we look at the table at 82, 176 is where unit cost for laying it, or I  
5 say the OFWAT figure for that is, if you like, laying pipe in a rural area? A. Yes.

6 Q And then when you come to pipe insertion you use a unit price of 227, and then you use a  
7 smaller unit price of 135 because you then reduce the size of the pipes – it goes under a  
8 river? A. That’s correct, yes.

9 Q Now, the third point that you made yesterday, and again I just want to know if I have  
10 understood it, that actually replicating the Ashgrove pipe system to Shotton has huge  
11 complications in terms of river crossings and contaminated land, that sort of thing? A. If  
12 one were to do it afresh?

13 Q Yes. A. Yes.

14 Q If I can just put a few questions to you on that basis, you accept that the Bechtell estimate of  
15 9.7 million is a fair estimate for replicating the main system – replication in the sense of  
16 laying the pipes afresh? A. I believe that that was as a result of a detailed engineering  
17 study and is therefore a sounder basis than any other estimates I have seen.

18 THE PRESIDENT: Just remind us when Bechtell was?

19 MR. RANDOLPH: I believe it was around the year 2000, Sir. United Utilities commissioned it.

20 THE PRESIDENT: Thank you.

21 MR. VAJDA: (To the witness) It is common ground there is a huge difference between 1.6, the  
22 way that you do it and the way that Bechtell do it to reach 9.7? A. Absolutely right, yes.

23 Q If you take your methodology, forgetting pipe-in-pipe for the moment, but just laying pipe  
24 across what I call virgin rural territory, you are, of course not replicating the Ashgrove  
25 system, are you, because you are not actually taking account of the problems of the rivers  
26 and the contaminated land, are you? You are not actually comparing like with like? A. I  
27 have not done that.

28 Q What we are looking at is the cost of replicating the Ashgrove system. I just want to  
29 understand how you have approached it, because you have approached it partly by pipe  
30 insertion – that is a small part – and then the major part is effectively laying pipe in a rural  
31 location. But the point you make yesterday, which is a perfectly fair point, is actually that  
32 the rural location here from Ashgrove, from Heronbridge to Shotton has various difficulties  
33 because there are lots of streams you have to go under, there is contaminated land ----  
34 A. No. No. There are two major areas which is what I reflected in my table ---- or,

1 sought to reflect in the way have approached this – that is, that there is the River Dee which  
2 has to be crossed, and that is an issue; and there is contaminated land which is an issue, and  
3 there are urban areas which are issues. I know, for example, that apparently someone has  
4 built houses over the route of the existing pipeline, which should not have been allowed, but  
5 it has. So, clearly, digging that up and replacing it would be slightly inconvenient.

6 Q Yes. My point is simply that you have quite properly drawn the Tribunal’s attention to the  
7 number of difficulties which would increase the cost of laying pipe afresh from Heronbridge  
8 to Shotton. All I am putting to you is that when you are looking at the 176 figure in Table  
9 82, you are looking simply at a rural location without any of these difficulties. A.

10 That is correct.

11 Q Yes. Absolutely. The difficulties you have mentioned – which is that somebody has built  
12 over the pipe and there is contaminated land, and crossing the River Dee ---- Those would  
13 be difficulties that would be faced by anybody who would wish to replicate the system, are  
14 they not? A. They are, yes.

15 Q Yes. Thank you.

16 THE PRESIDENT: Mr. Vajda, can I just ask: in your mind, when you talk about replicating the  
17 system, are you talking about, in some sense, taking up the existing pipe and putting a new  
18 one in where the existing pipe is, or are you talking about building another pipe alongside,  
19 or ----- What are we talking about exactly?

20 MR. VAJDA: We are talking about building ---- It is the latter. It is what it would cost  
21 somebody else to build this system without the existing system being there.

22 THE PRESIDENT: But the existing system is there.

23 MR. VAJDA: Yes, but what we have to do – and this is obviously where we will come on to  
24 submissions in law ----- We say we apply OFT414 which is the stand-alone cost of  
25 replicating the system. So, we have to start from scratch.

26 THE PRESIDENT: On the assumption that there is an existing system there or that there is no  
27 existing system there?

28 MR. VAJDA: On the assumption that there is no existing system there. It is obviously a  
29 matter of law that we will address. That is effectively what we say the OFT test is. (To the  
30 witness): I have just got some tiny points on this table at 82 – in fact, one last point – and  
31 then we can move on to 89. The unit cost figure that you use at 176, that is for a pipe of 600  
32 millimetres, is it not, I think? A. It is.

33 Q The Ashgrove is 700, is it not? A. That’s correct, yes.

34 Q Can I then ask you to turn over the page to the table at para. 89?

1 THE PRESIDENT: Just before we go there, Mr. Vajda, we have three tables in 81, 82 and 83.  
2 Although there are certainly points in relation to the various additional costs – river  
3 crossings, and so forth - which one must bear in mind, the essential difference between the  
4 various tables, as I read them, is what you assume in the unit cost figure for which they  
5 start.

6 MR. VAJDA: Yes.

7 THE PRESIDENT: You assume 465.40. I think that is explained in the evidence. Dr. Bryan  
8 has assumed 176 on the basis of 1999 costs, and 101 on what he says are the 2004 costs.  
9 Probably, at some point – not now – we shall need some help, or might need some help, on  
10 what is the right basis for this calculation to start.

11 MR. VAJDA: I see precisely where the President is going. On the question of replication, the  
12 issue is: is one going to be replicating, as it were, in Wales with, if you like, undulation and  
13 all the rest of it, or is one going to be replicating in East Anglia where it is totally flat? I  
14 think that is, in a sense, the question the President is addressing. Why is there such a big  
15 difference between 465 and 176.

16 THE PRESIDENT: Yes. I mean, it did look quite like East Anglia to us when we went up there  
17 – it was fairly flat.

18 MR. VAJDA: The Tribunal has the advantage of me.

19 THE PRESIDENT: You can read the contours on the map. It is just signalling a point that we  
20 will come to.

21 MR. VAJDA: Mr. Jones deals with it in his evidence.

22 THE PRESIDENT: You are going to 89?

23 MR. VAJDA: Yes. (To the witness): I think what you are seeking to do here is to try ----  
24 This is another cross-check, as it were, to show that your method of valuing the Ashgrove  
25 system is consistent with the OFWAT benchmark; is that right? A. No. No. It is to  
26 confirm, or to check ---- I try not to pre-judge the issues. It is to check whether the  
27 methodology I have used produces a result for the total raw water assets (and I use that in  
28 the terms that Dwr Cymru uses it, to include non-potable mains) ---- whether the total I get  
29 is consistent with the total MEA value for those same assets that Dwr Cymru admits to in its  
30 assets register, that figure being 102 million for 2004 and the calculations that we touched  
31 on yesterday that I perform gives me a total for those assets of 101 million – very close to  
32 the value that Dwr Cymru accept.

33 Q If we just look at the first class, which is aqueducts under 300 millimetres, you have got an  
34 average diameter of 250 ---- How did you get to 250? A. It is an estimation based on

1 my experience that there is actually very little point in laying long lengths of small diameter  
2 raw water mains. What would tend to happen is that small sources - and small diameter  
3 mains are associated with small sources – would typically be treated at or near their source,  
4 and put into supply. That is on the basis of my experience and I have seen no evidence that  
5 would lead me to think otherwise.

6 Q What do you say the length of the raw water duct system is for Dŵr Cymru? A. The raw  
7 water aqueduct?

8 Q Yes, what do you think the length is – could you tell the Tribunal? A. I have it in my  
9 witness statement. I know the figures Mr. Jones relies on, they vary.

10 Q Do you take the length as being 115-odd kms, or 542 kms, which do you take? Those are  
11 the two figures that have been ---- A. From memory, and I would need to check ---

12 Q Certainly, well would you like ---- A. 542 I think is the figure that has been quoted for  
13 raw water aqueducts in the sense that OFWAT defines them, i.e. supplying water between  
14 the source and the treatment works.

15 THE PRESIDENT: We have 583 in the table we are looking at? A. 583, yes.

16 MR. VAJDA: Yes, I am grateful to the President . That is your sort of ---- A. I believe I have  
17 taken that from Mr. Jones’s statement.

18 Q So that is how you calculate the length, that is your figure for the length of the raw water  
19 duct A. Yes.

20 Q But just coming back to the 250 you do not know whether there are a great number of very  
21 small pipes in that band or not, do you? A. No, I do not.

22 Q Now, the reconciliation, as I take it is for 2004, is that right? A. Yes.

23 Q Yes? A. Yes, I consider that the 1999 MEA values and the 1999 unit costs that Dŵr  
24 Cymru have published are unreliable, and I have tried to give explanations of why that is in  
25 my witness statement.

26 Q Do you accept there has been a fluctuation in cost between 1999 and 2004? A. I do  
27 accept that but not to the extent that is claimed by Dŵr Cymru.

28 Q Thank you. Well we can now move on to one last point on stand-alone and then we get on  
29 to non-potable/potable, and this is para.75 of the body of your witness statement. Perhaps I  
30 could ask you and the Tribunal just to read para.75, and I just want to ask you a question  
31 about the last sentence? A. (After a pause) Yes.

32 Q The question is: What do you believe is missing from the information that Dŵr Cymru has  
33 and has been disclosed to this Tribunal and you believe should be there? A.  
34 Contemporaneous evidence that supports 95 per cent. of the costs on which Mr. Jones relies.



1 Q I think you are making a slightly different point on what the 75 – 75 you are saying the  
2 Ashgrove supply has consistently generated more than 2 million ----

3 THE PRESIDENT: It was the last sentence you were asking about?

4 MR. VAJDA: Yes, but it is then “I am of the opinion that this represents a significant commercial  
5 activity and warrants an appropriate level of accounting attention and accuracy.” So what  
6 you are saying is because there is 2 million worth of revenue it warrants an appropriate level  
7 of accounting attention and accuracy, and the inference is that there was inappropriate  
8 accounting information and accuracy and I would like to ask you what should have been  
9 there that was not there? A. Well in answer to that, or to answer it as best I can, I draw  
10 your attention to the enclosure, I think, in Mr. Jones’s second witness statement – it may  
11 have been his first – which gives us the accounts for the cost centre which is Ashgrove, and  
12 we have accepted those at face value, there are one or two anomalies in there but we have  
13 accepted those at face value. We have also accepted, following a meeting and discussions  
14 with Dŵr Cymru, the allocation of certain management costs in relation to the operation of  
15 the Bretton Control Centre, and the physical management of the Ashgrove treatment works.  
16 In total, and forgive me, I do not have the figures in my head entirely, but in total those  
17 amount to some £100,000, I think, maybe £200,000, so we are talking about 5 per cent. or  
18 less of the costs which Mr. Jones claims are appropriately allocated to that system.  
19 There is no evidence that I have yet seen, certainly no accounting evidence that is  
20 contemporaneous, that underpins any of that 90/95 per cent. cost. So that is what I am  
21 saying. We had hoped that the third party cost rules in OFWAT’s regulatory accounting  
22 guidelines would have required Dŵr Cymru to account for those costs in a comprehensive  
23 and transparent fashion, but it appears from Mr. Jones’ testimony that he did not think that  
24 that was worthwhile, and OFWAT in their skeletons appear to support that view ,and so we  
25 are left with a very small fraction of the total costs being identified in accounting terms, and  
26 the rest being the subject of - in the absence of contemporaneous evidence – assertion  
27 of ----

28 Q What I would be very grateful for is if you could list one by one for the Tribunal the specific  
29 items that are missing? A. Well it is very difficult to make sure I get to them all.

30 Q Can we start with capital? Is that one of the items that you are referring to? A. There is I  
31 think by Dŵr Cymru’s own admission no record of capital other than the CCV value which  
32 is in SA11.

33 Q You see it is quite a serious attack on a company that it is not providing appropriate  
34 accounting attention and accuracy and so I am asking you, and I am asking you to tell the

1 Tribunal one by one what are the pieces of evidence that are missing? A. Well, you  
2 started with capital ----

3 Q Well could please tell the Tribunal what other items? A. Well I think we have already  
4 recognised that capital is the main one, management overheads, the allocation of rates, the  
5 allocation of debts which hare primarily a function of domestic potable supplies, the  
6 allocation of laboratory services which are not a feature of the non-potable system. I have  
7 dealt with them as comprehensively as I can in the detailed costs' assessment for Ashgrove,  
8 and so I am happy to go through those item by item, but each of those that I have mentioned  
9 we have no contemporaneous evidence from Dŵr Cymru as to what those costs are and,  
10 more importantly, how they should be appropriately allocated to non-potable systems in  
11 general or the Ashgrove system in particular.

12 Q Yes, well perhaps what we can do, if I could ask you to take up Mr. Jones's witness  
13 statement, this might help you.

14 THE PRESIDENT: Are we moving on to non-potable now? I think we should, Mr. Vajda.

15 MR. VAJDA: Fair enough, well I have made my point here.

16 THE PRESIDENT: You put the point to him and that is his answer.

17 MR. VAJDA: Yes.

18 THE PRESIDENT: That is his case. A. I am sorry, Mr. Vajda, did you want to ask me about  
19 the fax that you sent through late last night ----

20 Q Can that be done behind the scenes, Dr. Bryan? A. Yes.

21 Q It is probably easier if it is done behind the scenes.

22 MR. VAJDA: Except I did not send you any fax, Dr. Bryan, last night.

23 THE PRESIDENT: Your clients did, I think, Mr. Vajda.

24 MR. VAJDA: We are now then going back to average costs, Sir, and what we are now looking at  
25 is the differences between potable ----

26 THE PRESIDENT: Average accounting?

27 MR. VAJDA: Absolutely. (To the witness) What I would like to deal with first is what I call  
28 your methodology 7, and if we could just take that up from your fourth witness statement at  
29 para. ----

30 THE PRESIDENT: This is non-potable raw, as compared with potable?

31 MR. VAJDA: Yes, what is said is that raw is 2p, non-potable is the same so it should be 2p,  
32 absolutely, that is the point we are on. You set this out at paras.20 to 25 of your fourth  
33 witness statement, and you say that this is a very striking omission. Can we then go to

1 Annex F, because Annex F is, as I understand it, if you like the underlying analysis to your  
2 conclusion on this point, is this right? A. Yes, that is correct

3 Q What I would like you to just look at and read to yourself, and the Tribunal could look at as  
4 well, is para.12 on p.88? As I understand it what you are seeking to do here is to try and  
5 derive what is called the unit distribution cost? Is that correct? A. Yes.

6 Q What you do for raw water is that you find what the total cost is and then you divide it by  
7 how much is distributed? A. That is correct, yes.

8 Q Now, if we go back to your witness statement, paras. 22 onwards, as I understand it – and  
9 please correct me if I am wrong – you have failed to take account of the fact that over eight  
10 times the volume of raw water that is distributed by Dŵr Cymru is non-potable?

11 THE PRESIDENT: Sorry, say that again Mr. Vajda?

12 MR. VAJDA: You have failed to take account of the fact that over eight times the volume of raw  
13 water is distributed as non-potable water. What perhaps I can do to help the witness is if he  
14 could be given our skeleton argument on this which sets out the point? A. I have your  
15 skeleton argument.

16 Q If we go to para.16 of our skeleton? A. Yes, I remember it well.

17 Q If I could just point out a small typo for the Tribunal and witness in the second line of  
18 para.15, there is a “with” missing. “Albion seeks to contrast the cost of distribution of  
19 potable with raw water.” We apologise for that.

20 THE PRESIDENT: The concept of potable raw water would have thrown us somewhat out of ----

21 MR. VAJDA: Yes, I have to say it threw me somewhat when I re-read this.

22 THE PRESIDENT: Quite, thank you.

23 MR. VAJDA: (To the witness) We then set out, and can you just confirm that you agree with the  
24 way that we have characterised what we call your method 7 at para.16? A. No, I do not.  
25 I mean I take issue with the fact that you have said it marks a shift from Albion ----

26 Q Well leave aside the shift point, that is a sort of pleading point that I do not want to trouble  
27 you with. If we can perhaps focus on para.17. It is 16.2, 16.3, “Raw water has cost Dŵr  
28 Cymru approximately 2p to transport on a top down average analysis”. We say for the sake  
29 of the argument let us suppose that is correct. Then you say “The transportation of non-  
30 potable water must therefore also cost 2p”, and it is that that I want to ask you about,  
31 because your case is that the network of pipes carrying raw water and non-potable are very  
32 similar. A. That is true.

33 Q But you have not actually considered the difference in volumes being transported – and you  
34 can see that we have set them out for the Tribunal in the middle of para.17 that Dŵr Cymru

1 transported over 1000 megalitres a day of raw water, compared to only 123 megalitres a day  
2 of potable water. If one actually then looks at volume, and as you pointed out – that is why  
3 I took you to Annex F – one has to look at volume because it is a unit distribution cost,  
4 using your calculation one gets to a figure of non-potable of 17p, does one not? A.

5 Well, yes, but I am afraid your methodology owes more to Alice in Wonderland than it does  
6 to the water industry or, I suspect, any other industry. What you are assuming in this  
7 calculation, for this calculation to hold true, is that the cost of raw water transportation in  
8 total, which you rightly said, using my figures is approximately £7.5 million per annum -----  
9 For your arguments to make any sort of sense those same costs in total - £7.5 million –  
10 would also have to apply to the distribution of a much smaller volume of non-potable water  
11 through a much smaller network of pipes. That is nonsense, if you don't mind me saying so.

12 Q What are the respective sizes of the network? A. From the figures we have a raw  
13 water network that is approximately 583 km long, according to the information that we have  
14 received, and we have a non-potable network which we now believe is in the region of  
15 110km. There is over a five-fold difference in length. We know that some of the raw  
16 water aqueducts are very large indeed – greater than 900 millimetres. We have heard  
17 already that prices of mains laying increase geometrically with diameter rather than simply  
18 arithmetically. I don't see that there is any inconsistency in the conclusions that I have  
19 drawn.

20 THE PRESIDENT: I think we have struggled a little bit with this example, Mr. Vajda. You  
21 need to explain it to us at some point.

22 MR. VAJDA: The answer that you have just given me: are you using 542km for raw water or  
23 113km? A. You are comparing -----

24 Q 153. A. 153 is a figure that the Director relied on, and that Dwr Cymru relied on, and  
25 it is a figure that is now demonstrated to be wholly inaccurate.

26 Q Can I just ask you to go to Annex A of your witness statement? Perhaps I could ask both  
27 you and the Tribunal to read para. 16? (Pause whilst read): You have relied on the figure  
28 of 153, Dr. Bryan, to produce an average length of raw water aqueducts at 15.3. If we can  
29 just go back so that you and the Tribunal can see this ---- Can I ask everybody to go back to  
30 para. 28 of the witness statement at p.5? You have very helpfully set out a table of cost  
31 drivers. There you have average length – raw: 15. Of course, that 15 comes from the  
32 153km that you rely on at para. 16 of Annex A, does it not? A. Indeed, yes. Yes.

33 Q Yes. So, that is the figure we can forget about. A. I am sorry, Mr. Vajda, but you are  
34 confusing two different things. What I am trying to do – and referring back to that para. 16

1 of Annex A, that, if you remember, is responding to the Tribunal's very sensible question of  
2 trying to understand what the difference, or similarities are between different sorts of  
3 system. What I am trying to do is to say that what we are dealing with here – fundamentally,  
4 and the Authority makes it clear in their statement – primarily systems of 600 millimetres  
5 and above.

6 Q Yes. A. Now, that has been a very difficult problem for us to grapple with, simply  
7 because we have not known the breakdown, up until very recently, of either the non-potable  
8 mains or the raw water aqueducts. So, the 153 figure that I have used to derive the average  
9 length comparators in that table that you have referred me to at para. 28 of my first witness  
10 statement ---- That figure relates to the large raw water aqueducts of 600 millimetres and  
11 above. There is a direct comparator, in my mind, with the large non-potable pipes that we  
12 are talking about. In the argument that you bring in in para. 17 of your own skeleton, you  
13 are then talking about the totality of the raw water aqueduct system and the totality of the  
14 non-potable system. Now, I don't mind dealing with that, but I do actually agree with  
15 counsel for the Authority that it would be somewhat less confusing if we tried to stick,  
16 wherever possible, to pipes of greater than 600 millimetres because those are the class of  
17 assets serving the class of customer with which this case is concerned. But, there are times  
18 when we cannot avoid looking at other pipes. I have tried to make sense of it all.

19 Q What you are telling me is that in terms of length you are focusing on 153, because that is  
20 the like-for-like comparison. A. In trying to answer the Tribunal's questions as to  
21 whether these systems, i.e. the systems of the sort that supply Ashgrove, be it Ashgrove in  
22 isolation or Ashgrove and similar non-potable systems, it is appropriate – and indeed  
23 required because the Authority makes great play of ensuring we have a like-for-like  
24 comparison – to do just that, to look for a like-for-like comparison. If I based my  
25 arguments, or relied for my arguments on pipes that were 200 millimetres diameter, or less,  
26 you would very justifiably criticise me for doing so because they are not relevant to the  
27 Ashgrove system or to systems supplying other customers in that same class.

28 Q I think there is then common ground between us in the sense that what we have to focus on  
29 on the comparison is just the large raw water aqueducts. A. Where we can do so.  
30 Where we have the evidence. We are in a disadvantage here, and have been from the start in  
31 that information has been reluctantly given up and very often that information does not  
32 allow the breakdown the costs, the breakdown of capital values into those neat asset sizes.  
33 Therefore, where that evidence is not so broken down, I have had to make certain  
34 assumptions and make certain calculations, and wherever possible I have explained those so

1 that they can be criticised if I have got it wrong. I don't mind admitting to make mistakes.  
2 That is why I have tried to be as clear as possible about how I have reached the conclusions  
3 that I have.

4 Q It is just so that I understand – and I think I now understand – that the figure you are using  
5 to make the comparison, the 2p, is based on 113km of raw water pipes. A. No.

6 Q 153. I beg your pardon. A. No. No. No. Not at all. Not at all. The figure of 2p is  
7 an average figure. The figure of 2p, which appears to be accepted by both Dwr Cymru and  
8 by the Authority, and is consistent with my top-down analysis. That figure of 2p is, if you  
9 will, the regional average cost of transporting raw water through the raw water aqueduct  
10 system, be that from small bore holes through small pipes to very large river sources and  
11 reservoir sources through very large pipes. It is a regional average figure. My argument is  
12 that the regional average figure for non-potable systems is the same because there is no  
13 difference, no significant difference between the two systems that I can detect.

14 Q But when you are saying it is on a regional average basis, is it on the 153 or the 542? A.  
15 If it's on a regional average basis it's on the totality of the pipes and the totality of the  
16 volume through.

17 Q Can you just answer? Is it 542? Yes or no? A. Well, 542 ---- 583 ---- Whatever the  
18 figure is that Dwr Cymru admits to for the length of its raw water aqueducts.

19 Q So, that is the figure you are using to reach your conclusion that non-potable has the same  
20 cost as raw water. A. That's correct.

21 Q Thank you.

22 THE PRESIDENT: Just help me, Dr. Bryan. On para. 17 of Dwr Cymru's skeleton, can you  
23 just tell me again – because I am not sure I have completely got it yet – what is your  
24 essential criticism of the approach in that paragraph? A. Certainly. I don't have any  
25 problems with the analyses down to where we see the footnote no. 11 – 2p multiplied by the  
26 amount of water that comes through the pipes.

27 Q ... (indistinguishable) ... million. A. Indeed. The problem there is that then that is  
28 taken as a fixed sum that applies to any system. So, what Dwr Cymru has then done is  
29 divided that fixed sum, which relates to a very large volume of water going through a much  
30 larger raw water aqueduct system, and applied that fixed sum to the very much smaller  
31 volume of water that goes through the non-potable system. There is no suggestion  
32 whatsoever that I have seen that the total costs of running the raw water aqueduct system,  
33 used in its correct terminology as supplying the treatment works ---- that that total is exactly

1 the same as the total of running the much smaller non-potable system supplying customers  
2 such as Shotton Paper. But, that is the basis that Dwr Cymru use to create -----

3 PROFESSOR PICKERING: Your argument is that it is the average cost per cubic metre that is  
4 the same for raw water and non-potable, and not the total cost. A. That is correct.

5 MR. VAJDA: Can I just ask one last question? What assumptions did you make about the  
6 volume of water that went through the bigger pipes – the 153km of raw water? Did you  
7 make any assumption as to how much raw water went through those pipes and how much  
8 went through the smaller pipes? A. Yes, I did - not for the purposes of this exercise,  
9 but it is something that I have looked at.

10 Q Is this in evidence? Can we find it in your ---- A. I am not sure that it is, but I can help  
11 you through that. But, I don't believe that it is in evidence.

12 Q I can leave it on the basis that it is not in evidence. Obviously, if Mr. Thompson wants to  
13 deal with it ----

14 THE PRESIDENT: If there is a query about it, it can be sorted out behind the scenes.

15 MR. VAJDA: We need to press on. (To the witness): Can I now put some questions to you in  
16 terms of the big picture? You are saying that your retail activity entitles you to about a  
17 margin of 5p per cubic metre, does it not? That is what Mr. Jeffery says. A. No. I  
18 don't think we have talked about entitlement. I do not think Mr. Jeffery was responding to a  
19 question of what it would cost the efficient retailer. A. The matter of entitlement is  
20 something which has never informed our views on this case or indeed our original ----

21 Q Well remove the word "entitlement", but what Mr. Jeffery is hoping for is a margin of 5p,  
22 that is what his witness evidence is, is it not? A. His witness evidence was based on the  
23 cost that we will incur in providing our services when we replied, and I think it is important  
24 to recognise that we have no choice in the matter, we cannot look at non-potable in  
25 isolation. We are required by the Authority to deal with potable and non-potable, so that  
26 figure represents the requirement of our retailing functions for the customer across the range  
27 of services that we provide for him.

28 Q I am just doing this in terms of cross check ---- A. Of course.

29 Q -- because Dwr Cymru in carrying out its activities, we have treatment activities and  
30 distribution activities. A. Yes.

31 Q You say it is effectively entitled to somewhere between 3 and 4p and you are saying for  
32 distribution around 2p, but you agree that there is capital investment on the treatment side,  
33 and that there is capital investment that is required for the pipes. A. I am sorry, I am not

1 sure when you talk about “is required” I am not sure in what sense you are introducing  
2 that?

3 Q I am introducing it, when we looked at the stand-alone cost, do you remember, you agreed  
4 with me that the largest stand-alone cost was capital both for the treatment works and the  
5 pipes? A. Yes.

6 Q And you disagreed with me as to the amounts, but what I want to put to you is how is it that  
7 you can say that you should earn, or wish to earn 5p for a retail activity when Dŵr Cymru  
8 for both a treatment and distribution activity should be earning between 3 and 4p. Do you  
9 not accept that there is an incongruity between those two figures? A. I don't if one looks  
10 at the facts in this case. The facts in this case were that our contractual agreement with  
11 Shotton Paper which is before the Tribunal and is very clear in its terms, provides us with  
12 our retail margin on the basis of the benefits that we provide to Shotton Paper primarily  
13 through reducing the costs of their water to what we believe to be a more cost reflective  
14 level. That is where we find that margin. We are not seeking to say to Dŵr Cymru “We  
15 provide a much higher level of service to our customers than you do at much higher cost  
16 and therefore we require you to pay us for that service. That is not the way we go about it at  
17 all. We have an agreement with our customer and that agreement will provide for a  
18 workable margin in the event that we achieve what we have striven to achieve for the last 11  
19 years, which is a fairer price for the water supply to that customer.

20 Q Well let us move on, because I think we have established the relevant battle grounds here.  
21 Can I now ask you some questions about your original cost drivers in terms of difference?  
22 Remember that one of the factors that you relied on was integrity of pipes, do you  
23 remember that? A. Indeed I do, yes.

24 Q Now, you now accept I think that so far as integrity is concerned there is no difference  
25 between potable and non-potable, is that right? A. No, it is not right at all.

26 Q Well then, can we just look at your evidence on that? Can we start off by looking at – do  
27 you remember you had a meeting with Dŵr Cymru, I think this was very much at the  
28 Tribunal's suggestion, to try and agree where possible? A. I do indeed, yes.

29 Q And there was then an agreed, as it were, checklist? A. Yes.

30 Q Dr. Bryan, if you have **this**, called “Key documents”? What we are going to be looking at,  
31 Sir, and I need some help here as to where the Tribunal will have this document.

32 THE PRESIDENT: I do not know if there are spare sets of that rather useful looking volume, you  
33 have in your hand, Mr. Vajda, at some point it might be helpful for us to have it. What is it  
34 you want us to look for?



1 MR. VAJDA: It is the checklist of points following the meeting of 24<sup>th</sup> – and it is under cover of  
2 a letter to the Tribunal of 28<sup>th</sup>.

3 THE PRESIDENT: We have it.

4 MR. VAJDA: I am afraid, in order to understand this, we need to look at Mr. Jones's first witness  
5 statement, because this refers to – first of all, perhaps if I can just get everybody looking at  
6 the right page in the check list, it is p.5 of 12, the second check list?

7 THE PRESIDENT: Yes.

8 MR. VAJDA: (To the witness) And that I think, correct me if I am wrong, Dr. Bryan, that is your  
9 handwriting, is it not? A. Bear with me I am not sure I have the right check list.

10 THE PRESIDENT: Will somebody pass him a copy of the check list?

11 MR. VAJDA: Thank you very much. The check list starts on p.1 of 12. The first witness  
12 statement of Christopher Allan Jones.

13 MR. THOMPSON: I do not know if there are any spares. I had not anticipated this line of  
14 questioning, I do not think I have actually got it.

15 THE PRESIDENT: Well let us go on for the moment, Mr. Thompson and see if we can find a  
16 spare copy. A. I have a page of 5 of 12.

17 MR. VAJDA: Do you have 44 and there is a tick by that? A. 44 there is tick by that.

18 Q That, as I understand, is you agreeing to para.44? A. That is not my handwriting.

19 Q Oh, it is not. A. I think if you were to make your point, Mr. Vajda, I will do my best.

20 THE PRESIDENT: Why do you not put para.44 and see whether he agrees with it?

21 MR. VAJDA: Yes. (To the witness) This is in Mr. Jones' first witness statement. A. Indeed.

22 Q There is a tick by 44 and if we just go to the front of this checklist, it says "Checklist as  
23 amended by Albion and forwarded to Dŵr Cymru on 27<sup>th</sup> February 2006."

24 THE PRESIDENT: Where does it say that, Mr. Vajda?

25 MR. VAJDA: If one goes to the covering page, which is just before 1 of 12, of the second  
26 checklist.

27 THE PRESIDENT: Sorry, have we got more than one checklist?

28 MR. VAJDA: Yes, we have. The first checklist is from meeting on 24<sup>th</sup> February 2006. The  
29 fault is entirely mine. Then there is another checklist which is further back, going on, which  
30 is "Checklist as amended by Albion and forwarded to Dŵr Cymru", and that is the checklist  
31 that I have been working off? A. I am now with you.

32 THE PRESIDENT: I have a checklist that was sent to us under cover of a letter of 28<sup>th</sup> February.

33 MR. VAJDA: Yes, and in fact I think there are two effectively, that has two checklists. The first  
34 is headed checklist for a meeting on 24<sup>th</sup> February 2006, and that is 12 pages. Then behind

1 that there should be “Checklist as amended by Albion and forwarded to Dŵr Cymru on 27<sup>th</sup>  
2 February 2006.”

3 THE PRESIDENT: I am not sure we have the second one.

4 MR. VAJDA: I think it may help the Tribunal ----

5 THE PRESIDENT: Yes, but never mind, let us get on to the point. A. I do not have a problem.  
6 If you want to take me to para.44 of Mr. Jones’s first witness statement, I think we can  
7 actually move on from that fairly easily.

8 MR. VAJDA: Right, because you agree with para.44? A. If we see what Mr. Jones says, he  
9 says “There is no intrinsic physical difference between potable mains and ‘raw water  
10 aqueducts’ or ‘non-potable mains’.” That is crudely referred to a pipe is a pipe is a pipe,  
11 and we accept that, and we said so at the meeting. He then goes on to say “When a new  
12 main, (for the transport of whichever type of water) is laid, pipe sections of appropriate size  
13 are ordered from the same stock of mains.” We can indeed agree with that. The problem  
14 with that meeting was that we said “That is not the whole story”.

15 Q No, I understand that. If we want the whole story, Dr. Bryan, we would be here for weeks  
16 and weeks.

17 THE PRESIDENT: Well you are asking him about the integrity of the pipes.

18 MR. VAJDA: And it is para.44 which he says he agreed.

19 THE PRESIDENT: What you are seeking to infer from his agreement to para.44, that he accepts  
20 that there is no difference as regards the integrity of the pipes, is that right? A. Paragraph  
21 44 does not relate to integrity.

22 MR. VAJDA: Right, well perhaps you could tell the Tribunal now what features make a  
23 difference in terms of cost drivers having regard to your agreement to para.44, simply  
24 looking now at the physical characteristics of the pipe work. I will come on to matters of  
25 location and so on in a moment. We are just looking at the actual, physical ----

26 THE PRESIDENT: What are we talking about when we get to “integrity”, Dr. Bryan? A. We  
27 are talking about how important it is that the main is robust, and remains robust; how  
28 important it is that the quality of the water within that main remains as it was, or as it should  
29 be. We are talking about the ability of the main to provide water at the necessary pressure,  
30 for example, which has a direct bearing on it. We are talking about the complexity of the  
31 system. It is well known to anyone with the slightest experience of home plumbing that a  
32 single pipe is less troublesome than a complex central heating system.

33 MR. VAJDA: At the moment I am just focusing on the question of a pipe is a pipe. We will  
34 come to complexity, I know you have a new point and I will come to that. We are just

1 looking at the physical characteristic of the pipe. You mentioned “pressure” which I am not  
2 going to take you to, that is dealt with in evidence. What else, apart from pressure, are you  
3 quibbling about in terms of the physical characteristics ---- A. Complexity.

4 Q No, not complexity, simply the physical differences. A. Is that not a physical difference?  
5 If I have a single pipe between points A and B, and I am comparing that with a system  
6 which is a very complex network of pipes I consider that to be a physical difference. It  
7 would certainly have a profound effect on how I would manage that system.

8 Q Can I put this to you, Dr. Bryan, you have been in this industry for, I think, 32 years, you  
9 draft your own Notice of Appeal, and you mention – if we look at the Notice of Appeal – a  
10 number of factors ----

11 THE PRESIDENT: Sorry, where are you in the Notice of Appeal?

12 MR. VAJDA: Paragraph 179. (To the witness) 179, as I understand it, was effectively the main  
13 cost drivers which led to a difference in the cost of distribution of potable and non-potable.  
14 A. It is a very brief summary of the facts.

15 MR. VAJDA: There is no reference there to complexity at all, is there? A. If I refer you earlier  
16 in the Notice of Appeal, particularly to the diagram on p.13 of that Notice of Appeal, I think  
17 you get some measure of the complexity point that I am making.

18 Q Would you like to expand on that? A. In essence, that diagram – and I am trying to  
19 make the Notice of Appeal as comprehensive as possible, and as coherent as possible –  
20 shows that the Ashgrove system to the top right of that diagram is a very simple system, a  
21 point-to-point system, which is comparable in my mind to the raw water elements of the  
22 systems to its left. What you are asking me to do is to compare, if you like, the hatched box  
23 that relates to the Ashgrove system with potable systems.

24 Q No, I am not. What I am asking you is why, at 179 we were looking integrity, and you have  
25 given me a number of answers now about complexity, and I know that in your latest witness  
26 statement you deal with complexity, which I will come to ----- But, there is no reference to  
27 complexity here in terms of that being a feature that goes to integrity. That is the point I am  
28 making. A. It certainly is a feature that goes to integrity because it is very much more  
29 difficult to keep a complex system to maintain the integrity of a complex system.

30 Q Well, let us try and deal with this as quickly as possible. So far as integrity is concerned,  
31 your two points how are pressure and complexity; is that right? A. No. They are two  
32 of my points.

33 Q What are your other points on integrity? A. The other points on integrity are that the  
34 quality of the water that goes through non-potable and raw water pipes is of no concern to

1 the Drinking Water Inspectorate. There are no quality requirements on them by and large.  
2 There clearly are within potable systems.

3 Q I am just looking at integrity at the moment.

4 THE PRESIDENT: But you asked him what the other points were. A. This bears on  
5 integrity because the Drinking Water Inspectorate, as I think has been fully accepted, has  
6 required Dwr Cymru to spend a large amount of money replacing, relining, refurbishing  
7 potable mains because the quality of the water flowing through them was being degraded,  
8 and that was not acceptable. Now, that is all to do with integrity – the integrity of the  
9 system. That has required Dwr Cymru, as it fully accepts, to spend a lot of money replacing  
10 potable mains. That same costs driver is absolutely absent in both raw water and non-  
11 potable systems.

12 MR. VAJDA: If we just examine that for a moment, you said a moment ago when we were  
13 looking at raw water, we needed to compare like with like. So, we had to compare large  
14 pipes with large pipes; is that right? A. Yes.

15 Q Yes. Now, in relation to this investment in drinking water – potable – was that in large  
16 potable or small potable pipes? A. I've no idea.

17 Q You have no idea. A. No. I would imagine that the majority of it was in the smaller  
18 pipes.

19 Q Yes. Well, that is in fact the evidence of Mr. Jones, is it not? We are trying to compare like  
20 with like. It is somewhat misleading, is it not, Dr. Bryan, particularly for somebody who has  
21 got thirty-two years' experience in the industry, to suggest that there is all this investment in  
22 relation to potable if you are now telling me you knew that in fact it was only in relation to  
23 the small diameter which is not comparable to the non-potable system that we are looking at  
24 because we are looking at bulk distribution and not local distribution? A. You asked  
25 me about cost drivers.

26 Q I did. A. I made no comment – and I have made no observation – on the quantum of  
27 the cost driver relating to quality and potable systems. I have simply responded – and  
28 rightly so – to the Tribunal's desire to find out whether there is any difference in costs  
29 drivers. It is, without a shred of doubt, a difference in the cost driver that potable systems,  
30 no matter what their size are subject to a requirement to maintain the quality of the water  
31 within them. Where those costs fall within the potable system, and whether they  
32 disproportionately fall on the smaller pipes, is something that I will readily agree, but it does  
33 not alter the fundamentals – which is that no raw water pipes are ever likely to be replaced  
34 because of the quality of the water flowing through them. That is the case with potable.

1 Q I think we see what you are saying on that. Let us move on to location. I think this was  
2 another point you made. I think your position here is that potable are mainly in the urban  
3 areas, and non-potable are in the rural areas. Therefore, potable is more expensive. Is that a  
4 fair way of putting your case? A. It is a simplification, but I think it is reasonably fair,  
5 yes.

6 Q If I could just ask you to take up Annex A of your last witness statement, which is your  
7 fourth witness statement ---- If I could just ask you and the Tribunal to read paras. 65 and  
8 66? (Pause whilst read): Now, you will recall that Mr. Jones, in his first witness  
9 statement, produced some maps on this location point which you criticised at paras. 65 to  
10 66. A. Yes. I have not criticised the maps.

11 Q You have criticised the conclusions that he makes. A. Yes.

12 Q Can I ask you now to take out the map which is exhibited to Mr. Jones' third witness  
13 statement ---- The map I would like to take the witness to is CAJ11. It looks like this.  
14 (Indicated) Exhibit 1. A. These are the two maps of North Wales and South Wales.

15 Q If you look at the South Wales one ... What Mr. Jones says in his third witness statement  
16 is that if we take, for example, Swansea and Cardiff ---- Perhaps I should just explain to the  
17 Tribunal and the witness how this has been done. Yellow is basically rural; grey is urban.  
18 For the keys, A is source; B is a treatment works; S are non-potable customers; W are  
19 potable customers. That is, if you like, the key to the map. It is not obvious from that, is it -  
20 --- If you look, there is a huge amount of potable distribution in Swansea and Cardiff, as one  
21 would expect, because they are large cities. But, it is not obvious from that, is it, that that is  
22 actually there for large potable customers in those areas? A. I am sorry. The point you  
23 are making is?

24 Q Well, how can you tell from this map that potable customers ---- potable pipes that we are  
25 looking at for large potable customers ----

26 THE PRESIDENT: Can you just remind us: what is 'large' on this map? What sort of volumes  
27 are we talking about?

28 MR. VAJDA: Ten for customers.

29 THE PRESIDENT: The ten largest you mean?

30 MR. VAJDA: The ten largest, yes. A. But, on a like-for-like basis these are very small  
31 customers compared with non-potable customers.

32 Q Why we are going to this is because a major part of your case is that one of the fundamental  
33 distinctions between non-potable and potable is that basically non-potable is in the  
34 countryside and therefore cheaper, and potable in the urban areas. All I am saying is that

1 when one looks at this map, one cannot actually deduce that from this map, can one? A.  
2 Can I respond as best I can?

3 Q Yes. Certainly. Can I say first of all that I have significant trouble with this map, because it  
4 shows, for example, that Herefordshire is very heavily populated with rural areas. If one  
5 looks closer to home and closer to this particular case ---- So, if one takes the North Wales  
6 map, I have some doubts in my mind about the definition of 'urban'. I think that what you  
7 have done is that you have used ordnance survey digital information which relates to  
8 settlements of any size. To give an example of that, if one looks on the North Wales map  
9 at the Ashgrove system, which is helpfully shown in green, running from A10 to S10, we  
10 have along the length, approximately half-way along the length of that green line, a little  
11 grey area to the north-east of that pipeline. That is Sealand. It is the hamlet of Sealand. I  
12 thought you might ask me this question, and I did a Google (wonderful what technology  
13 does!) aerial photograph of the hamlet of Sealand. As far as I can make out, it comprises a  
14 couple of houses and perhaps a pub along one side of the road. It does not constitute, in my  
15 mind, an urban area. Therefore, I am not sure that this is a satisfactory basis for ----

16 Q Dr. Bryan, we are looking here at regional averages. This is not stand-alone. Your case is  
17 that looking at this across DC's network as a whole it is much more expensive to distribute  
18 potable than non-potable water. Your case is based on ---- A. Well, no, that is your  
19 case.

20 Q No. No. A. It is Welsh's case that potable is much more expensive to distribute than  
21 raw water ----

22 Q No. This is a challenge to the decision of the Director who concluded that the cost of  
23 distributing potable and non-potable was the same. You are challenging that, and one of the  
24 bases of your challenge is that you are saying that in fact the cost of distributing potable  
25 water is significantly higher than non-potable. A. That is correct.

26 Q One of the bases of that is that you say that actually, looked at ---- We are looking at  
27 regional average pricing that potable pipes are generally to be found in urban areas and non-  
28 potable in rural areas. So, one has to look at it across the board, does one not? A. One  
29 does, yes. I think that that is demonstrably apparent from the maps – even though I question  
30 the basis on which they have been ----

31 Q I do not think I need to explore that further. If I can give you, sir, the reference because  
32 there has been a quibble about the basis on which the map has been produced ---- The  
33 Tribunal does need to take it up. It is at footnote 5 to Jones 3, where he explains that it was  
34 done on data supplied by the Ordnance Survey.

1 THE PRESIDENT: On a point of information, Mr. Vajda, which may not get us anywhere, but  
2 just out of curiosity, I think we have been told that there is now one potable customer over  
3 1,000 megalitres daily. If you could just identify which one that is on the map, that would  
4 be helpful – not necessarily now, but at some time.

5 MR. VAJDA: Yes. I am sure those behind me will be able to assist. I have been told it is W1.

6 THE PRESIDENT: That sounds logical.

7 MR. VAJDA: Can I then come to the next difference in cost driver, which I think you say is  
8 length, and if I can just take you to para.28 of your witness statement. We looked at this  
9 before because this is one where I asked you some questions about how you got to the 15  
10 kms for raw? A. Yes, indeed, yes.

11 Q What you are saying here, as I understand it, is the length for potable customers is more  
12 than twice as long as the length for non-potable. That is your case here is it not? A. That  
13 is my estimation, yes.

14 Q And that is something which you relied on in your Notice of Appeal. A. Yes.

15 Q Now, can we just go to Annex A to see how this is done? When you look at non-potable, if  
16 I could just ask Dr. Bryan and the Tribunal to read para.6 on p.15 of Annex A, the first  
17 page.

18 THE PRESIDENT: Yes.

19 MR. VAJDA: As I understand it for non-potable you say “Well, actually, we have, say, the  
20 Ashgrove system, it serves two customers. If the length is, say, 16 kms, look at it, average  
21 length by customer, two customers, so it is 8 kms.” That is how you do it for ---- A.  
22 That was how I reached the figures, yes, over the generality of customers, yes.

23 Q Yes. Then if we go over the page you tell us how you do it in relation to potable customers,  
24 and if I could just ask you, Dr. Bryan, and the Tribunal to read para.11.

25 THE PRESIDENT: Yes.

26 MR. VAJDA: Here you are looking at – you are not doing it on a per customer basis any more –  
27 you are taking the average distance between the 10 large customers and their closest water  
28 treatment works? A. Yes.

29 Q So you are not actually comparing like with like, are you? A. No, the systems are quite  
30 different and therefore like for like ceases to have any bearing in reality, I think.

31 Q Do you know how many potable customers Welsh has? A. More than 1000 megalitres a  
32 year?

33 Q No, if one is simply looking at - you are looking here as I understand it, are you looking at  
34 large potable customers, or all potable customers? Just large? A. The devisor that I used

1 in creating the 8 kms length was large and very large non-potable customers. There are  
2 very few very large potable customers.

3 Q Yes. Fine, well that is all I want to ask you then on length, and I now move on to  
4 complexity, which you have already touched on and this is the point that you now make, as  
5 I understand it, if we can go – still in Annex A ---

6 THE PRESIDENT: We sometimes take a break, Mr. Vajda, mid-morning, I do not know whether  
7 it might be convenient just for five minutes to do so.

8 MR. VAJDA: Yes.

9 THE PRESIDENT: Right, five minutes.

10 (Short break)

11 MR. VAJDA: Sir, I have had a reflection in the break about this cross-examination and it occurs  
12 to me, subject to the view of the Tribunal, because I am very conscious of time and the need  
13 to move on, that I propose now not to put any other point on cost drivers. With all these  
14 points we could be here for a very long time.

15 THE PRESIDENT: Yes.

16 MR. VAJDA: These points are made in the evidence, we have made a lot of these in our skeleton  
17 and given the indication that you gave last time ... otherwise we would be here for a week -  
18 ---

19 THE PRESIDENT: Well it is very much up to you, Mr. Vajda, if you want to ask the questions I  
20 am not going to stop you.

21 MR. VAJDA: No, but I am conscious of the time, and I have some more questions on cost  
22 differences, these are points, some of which we have already effectively put in our skeleton.  
23 There is dispute on the evidence between Mr. Jones and this witness, and I would ----

24 THE PRESIDENT: It is entirely up to you. We are at your disposition and so is Dr. Bryan, I  
25 think.

26 MR. VAJDA: Yes, yes. I think what I will then do is to just deal with one last area which is  
27 activities at Shotton.

28 THE PRESIDENT: Yes , very well.

29 MR. VAJDA: (To the witness) So we are now moving, and this is the last area I am covering  
30 with you, I am now focusing on what you are actually doing at Shotton. A. Yes.

31 Q Can you tell me, or tell the Tribunal, what you are doing that avoids Dŵr Cymru incurring  
32 any cost that it used to incur? A. I can tell you what we are doing ----

33 Q Maybe the easiest thing for the Tribunal and myself, if you could number them – start with  
34 point 1, and just go through one by one the things ----



1 THE PRESIDENT: Let us see what they are doing first.

2 MR. VAJDA: Yes. A. Well we are providing a comprehensive water supply service to  
3 Shotton Paper, comprising both a potable supply, the terms of which are not subject to this  
4 Appeal, and a non-potable supply the terms of which certainly are. Within that we then  
5 work with Shotton Paper as it has been evidenced, in partnership to ensure that their use of  
6 the water that we supply them with is as efficient as possible. We see that as an important  
7 responsibility of a water undertaker responding both to the statutory obligation all water  
8 companies are under to promote efficient use of water conservation and we also see it as an  
9 essential component for any water undertaker that is seeking to compete in an extremely  
10 difficult market.

11 THE PRESIDENT: What does that physically mean, Dr. Bryan, can you just paint the picture for  
12 us, day by day or week by week? A. Physically day by day it means that we have a  
13 manager who is pretty well dedicated to Shotton. That is largely a factor related to the fact  
14 that he is based in Chester. He would also have time to manage the supply to Corus were we  
15 able to supply them, so I am not saying that his time needs to be fully committed, but at the  
16 moment that is our sole business in that area. His job is to understand an extremely complex  
17 plant, extremely complex processes within that plant and the dynamics of it, and to  
18 understand how water is used in that and where water might be used effectively. It is also  
19 his statutory role to ensure that the potable water, and as I have said before we are allowed  
20 to distinguish potable from non-potable in terms of our statutory responsibilities to that  
21 customer. It is also his duty to ensure that that customer continues to protect the quality of  
22 potable water within a very complex system and that that water is not compromised or  
23 contaminated by coming into contact with a much larger volume of non-potable water. The  
24 network within that particular paper mill is as complex as with a much larger geographical  
25 network that will be used, for example, to supply domestic customers. I know we are not  
26 comparing like with like ----

27 THE PRESIDENT: This is the water distribution network within the ---- A. Water distribution  
28 within the Mill. Everything from the water needed on the actual paper machines, the water  
29 needed to disintegrate the recycled newspaper that is used as the feed stock for that, down to  
30 things like the safety showers and for the operation of the canteen. Albion has a  
31 responsibility for ensuring that water quality is maintained within that system. We are at a  
32 disadvantage as any inset appointee is, is that no matter how big or, indeed, how small our  
33 customer base is the Drinking Water Inspectorate classifies that area as a water distribution  
34 zone and, as such, that triggers a very significant amount of water quality analyses that have

1 to be undertaken again on the potable side. But those activities in the round have enabled us  
2 in partnership with Shotton Paper to reduce their water consumption from 16 m<sup>3</sup> per dry  
3 tonne of paper produced back in 1999 - it was actually significantly higher than that when  
4 we first became involved – down to a level of 13 cubic metres per tonne of paper. We are  
5 currently working with them to achieve 12 cubic metres per tonne. They, of course, are  
6 benchmarked against UPM’s international operations. Their ambition is to achieve world  
7 class which would be 9 cubic metres per tonne. We cannot do that for them. They cannot do  
8 it without our assistance. It is, in that sense, a genuine partnership. But, I think their  
9 behaviour and their support for us over the last eleven years has amply demonstrated.

10 Q Just remind me: we did not exactly meet your manager when we went up to Shotton, but I  
11 seem to remember that someone was there. A. Yes, indeed. A representative of the  
12 plant was at the Sealand end, and accompanied us, I think, round the ----

13 Q This is the gentleman you have referred to? A. No, it is not. The gentleman I have  
14 referred to there ---- There has been a change of personnel, but the gentleman I have  
15 referred to now is the senior representative at the site who is responsible for water amongst  
16 a whole range of production issues.

17 PROFESSOR PICKERING: Can I just ask: of that saving from 16 to 13, what proportion of  
18 that is represented by potable and what by non-potable? A. It is all non-potable.

19 Q That is all non-potable. A. That is all non-potable.

20 Q Right. What had been the trend? I do not know whether you happen to have any figures  
21 about the trend in water consumption and efficiency on non-potable before you took over?  
22 A. Not so much a trend, Professor Pickering, as stability. What was happening – and still  
23 happens to a much lesser extent – is that the machine ---- the plant ---- the paper-making  
24 plant operates best ---- operates at its most efficient when these very large machines run  
25 twenty-four hours a day, 365 days a year, or for long periods of time. What was happening  
26 was that those machines would be forced to shut down. In many cases, the cause of those  
27 shutdowns was related to water?

28 THE PRESIDENT: In what way? A. Well, some of those problems were mill-related, and,  
29 for example, they were using the raw water – the non-potable water – to seal various  
30 devices, particularly pumps. That sealing water would become contaminated with oils. The  
31 oils would then get into the system because the water is re-circulated and recycled as far as  
32 it is possible to do, and we would then get a build-up of oil and very fine part fibres of  
33 wood/paper that would block the filters that supply the water to the paper machines. The  
34 paper machine stops, and you then have a ----- If you ever see it, it is spectacular. It is

1 something like a 10metre wide sheet of paper travelling at 60mph and when that breaks, not  
2 only does all hell break loose, but you then have a sea of pulp that then needs to be cleaned  
3 up. So, it was those incidents that influenced the smooth-running of the machines that were  
4 the major cause of excessive water use. What we have done, together with Shotton Paper,  
5 is identify the causes of those problems, and try and prevent them. But, some of the  
6 problems occur outside the plant because of the low and variable quality of that non-potable  
7 water. Indeed, the week after ----

8 THE PRESIDENT: What do you mean by that? A. Well, the Ashgrove treatment works is  
9 not of a particularly high quality – and there is no requirement on the supply to be of high  
10 quality – and it is variable. So, there are times when rather more particulate matter is taken  
11 over into supply than at other times. That causes problems. There was an incident  
12 immediately after the last hearing when a large amount of weed was dislodged from  
13 Ashgrove and found its way into the mill and caused a shutdown there. Now, to be fair,  
14 although we have challenged Welsh on this, Welsh still claim that the weed was not their  
15 responsibility. So, that is not a settled matter. But, there is no doubt that those external  
16 influences have a profound impact on the plant. We are in discussion with Shotton – as,  
17 indeed, we have been for a large number of years – about what we would like to do if we  
18 had the necessary commercial basis on which to do it – which would be to take that low  
19 quality water and treat it at the Shotton Paper end to a standard that would obviate these  
20 problems and use the same process for supplying Corus’ requirements if they still required  
21 us to be their supplier. So, that is, in broad brush, a picture of what we do and what we  
22 aspire to do.

23 PROFESSOR PICKERING: So, that is technical advice and consultancy, is it not, in significant  
24 measure? A. It is certainly technical advice. But, I do not see that as something that  
25 is outwith our definition of the service that we provide to a very large customer. I do not  
26 believe that I can go into the commercial competitive market and say, “We will sell you a  
27 very large volume of water, currently at a very high price, and, by the way, if you want to  
28 know how to use it better we will then charge you again”. I believe that the water industry  
29 – not just at the industrial level, but also at the domestic level – needs to be very much more  
30 aware of water resource issues that this country faces; of the need for conservation. If we  
31 simply see it as an added extra which we only provide if we are paid for it, then the current  
32 situation is going to get markedly worse. So, I make no excuses about our belief that the  
33 service we provide is a very hands-on service – obviously consistent with the value of the

1 business that we are providing, but that that should include the sort of specialist advice that  
2 only a specialist water company can provide.

3 MR. VAJDA: Following on from the question that Professor Pickering asked, he said that these  
4 were essentially technical consultancy services ---- Is there anything that you do which is a  
5 regulated activity in what you have described – a regulated water activity? A.

6 Everything we do that have just described is encapsulated in the regulatory returns that  
7 Albion makes to the Authority. So, in that sense, yes, it is. I am not aware that there is a  
8 detailed handbook of what comprises a regulated and non-regulated service. It is obvious at  
9 the extremes, but nothing we do is inconsistent with what other water undertakers have done  
10 as part of their regulated business when the circumstances arose.

11 Q I am just asking you, just as a question of fact: the point that Professor Pickering made is  
12 that you are providing essentially a consultancy service. What I would like to know, simply  
13 as a question of fact, is: are you providing anything other than the consultancy and technical  
14 services that Professor Pickering referred to, and specifically are you providing any  
15 regulated services? A. I have just told you, all those services we consider to be  
16 regulated.

17 Q Could I ask the Tribunal to turn up a letter that you wrote on 24 April, 2006? (Handed)

18 THE PRESIDENT: I do not know that we have been copied in on this.

19 MR. ANDERSON: It was a series of letters passing between the Authority and Albion,  
20 requesting certain financial information about these consultancy services provided to  
21 Shotton.

22 THE PRESIDENT: We have got a letter from OFWAT to Dr. Bryan of 21 April, and a reply of  
23 24<sup>th</sup>.

24 MR. VAJDA: That is the relevant correspondence that Mr. Anderson referred to. I think the  
25 letter of 21<sup>st</sup> was a request for ----

26 THE PRESIDENT: It is a letter seeking disclosure.

27 MR. VAJDA: Then we have the response of Dr. Bryan to that request for disclosure. He  
28 effectively declines the request, but says, “In a spirit of co-operation, I offer the following  
29 observations on each item in your schedule”. Then we see at (2): “We currently provide no  
30 non-regulated services for Shotton Paper although Envirologic did provide some prior to  
31 2003”. So, that is the position, is it not? A. Yes, it is, yes. That is what I have said.

32 Q Well, it is not quite what you said, with respect. You said it was put in your regulatory  
33 terms ---- It certainly gave me the impression – or perhaps I was mistaken – that you were

1 suggesting that this was a regulated ---- But, the position is as set out in your letter, is it  
2 not?

3 THE PRESIDENT: Let us just be clear. I understood the witness to be saying that he regarded  
4 the services that he has just described as regulated services.

5 MR. VAJDA: That is what I understood.

6 THE PRESIDENT: He said in para. 2 that he provides no non-regulated services.

7 MR. VAJDA: Yes.

8 THE PRESIDENT: He views these services as regulated services.

9 MR. VAJDA: Yes. But, my next question is this: do you need to be a regulated water  
10 undertaking to provide these services? A. What do you mean by ‘these services’?

11 Q The services that you have described to Professor Pickering and the Tribunal – the technical  
12 and consultancy services that Professor Pickering asked you about a moment ago. A.  
13 It would technically be possible to hire an independent consultant to advise on a range of  
14 those issues.

15 Q Yes. So, the answer is that you do not need to be a regulated water undertaking to provide  
16 the services ---- A. I don’t think I’ve ever claimed that you do.

17 Q No. It is just for clarification.

18 THE PRESIDENT: Do we have a definition somewhere of ‘regulated services’?

19 MR. VAJDA: I am sure that Mr. Anderson ----

20 THE PRESIDENT: It does not matter now, but at some point, if this is going to be pursued, we  
21 may need to see what it means.

22 MR. VAJDA: Absolutely. (To the witness): Apart from what you have described to the  
23 Tribunal, do you do anything else, or is that effectively it? A. With regard to Shotton?

24 Q With regard to Shotton. A. Well, as I said in my letter to Mr. Booker, here, we  
25 currently have no plans to provide other regulated services until this appeal is resolved and  
26 we can ascertain the commercial viability of future opportunities.

27 Q The description that you have given the Tribunal – that is the complete description of what  
28 you are doing at the moment – what services you are providing to Shotton; is that right?

29 A. It is a summary of a very complicated and technically complex series of services, but,  
30 yes ---- I do not think I have left anything out.

31 Q No. We can take that as a fair summary. A. Yes.

32 PROFESSOR PICKERING: Another way of putting that question, may I suggest, if you would  
33 allow me, Mr. Vajda, is: are there any other activities that you would claim Albion has now  
34 replaced Dwr Cymru in providing as a retailer to Shotton Paper? A. The answer, as far

1 as we can tell, is 'No'. We offer to do the billing, the meter reading on their behalf, and  
2 allow them access to audit those figures. We even offer to buy the system from them –  
3 although that was while we were still in joint venture with Pennon. But, no, Dwr Cymru  
4 have consistently declined to rely on our meter readings, and so they still send their own  
5 meter reader who tends to meet our local manager. No, I think it is true to say that Dwr  
6 Cymru have not chosen to discontinue any of the activities.

7 MR. VAJDA: In relation to these consultancy activities, you have indicated to us, I think, that  
8 you have had considerable success in reducing the amount of water that Shotton uses. You  
9 use the term 'consultancy' as a ---- A. Well, it is Professor Pickering's term ----

10 Q Yes, I know, but you are using it as a way of ---- A. I am using it ... (overspeaking) ...  
11 for those activities. We provide the technical assistance as part of what we do for Shotton.  
12 As part and parcel of that, the effect of those services is that we have helped them to  
13 improve their water use efficiency very substantially.

14 Q Yes. So, the position is this: that the beneficiary of these services is Shotton; is that right?  
15 A. Yes.

16 Q They have, as a result of these services, saved money. A. Yes.

17 Q So, presumably, and perhaps you can tell us, are you rewarded for these services by some  
18 form of cost sharing – that if you manage to reduce the costs by so much, you get a  
19 percentage of the saving? A. Not in those cases because ----

20 Q How are you remunerated? How do you share in the success of reducing the water  
21 consumption of Shotton? A. That is part of our job. We see it as part of our job. Our  
22 payment for that would be in the form of a margin on sales, were we to achieve a cost  
23 reflective bulk supply price or common carriage charge. The difficulty in doing what you  
24 propose is that within our Customer Service Agreement with Shotton Paper there is an  
25 explicit formula that allows for the sharing of benefits. Now, that is fine. When, as I hope,  
26 we will be able to come back to Shotton Paper and say, "We have a fairer price for water",  
27 those benefits will be (a) readily measured, and (b) clearly attributable to Albion. The  
28 difficulty with sharing the benefits of improvements such as I have described – which have  
29 happened over a seven year period – is that it is a partnership effort, and for us to claim all  
30 the credit is not a very good basis on which to conduct a partnership. So, we view from a  
31 practical as well as a commercial point of view ---- we view the ongoing incremental  
32 efficiency benefits that we help Shotton Paper to achieve as part of the service, and we do  
33 not seek to recover anything additional by way of payment for those – rather, we see it as

1 something which helps cement the relationship, and we hope that we can rely on when we  
2 come to re-negotiate that contract in the fullness of time.

3 PROFESSOR PICKERING: This is the 70:30 formula, is it not? A. Yes.

4 Q Shotton gets 70 and you get 30 percent of the savings ---- A. Of a defined benefit.

5 Q Are you saying that you could claim that at the moment but are choosing not to do so, or are  
6 you saying that it only kicks in when you have, as you hope, obtained a lower price on  
7 which you can deliver generally? A. We are saying that it only kicks in when we have  
8 a defined benefit when we can agree with Shotton what the starting point is. We can agree  
9 with Shotton what the end point is and therefore where the benefit is. We can ascribe that  
10 benefit to our activities, and ongoing benefits, which run across the whole scope of an  
11 extremely complex manufacturing operation and which happen over a period of seven  
12 years, and which fluctuate over that period. It may be 13 m<sup>3</sup> per tonne today, it may be 12.8  
13 tomorrow and 12.9 the following day.

14 Our experience over more than 15 years now is that trying to put those sort of incremental  
15 gains into a benefit sharing exercise is incredibly difficult and usually leads to bad feeling  
16 and therefore in practice if we are going to have a share of benefits we define specific  
17 projects, where we can have a start point, we can have an end point, we can have a defined  
18 gain and there is no dispute about Albion's contribution.

19 Q Have you had any of those at the moment? A. Right at the outset – I cannot remember  
20 whether it was in Dŵr Cymru or the Authority's skeleton, they pointed out the fact that the  
21 original retail price was 27.8p and the determination of the Authority (Director as he was  
22 then) was that it should have been 26p. What happened at that point was that Dŵr Cymru  
23 immediately reduced their retail price to 26p. That resulted in the defined benefit. That was  
24 well before the inset appointment was made and the resultant benefit was shared on a 50:50  
25 basis at that stage over a period of 12 months, and I think from memory resulted in revenues  
26 to Albion of some £50,000.

27 MR. VAJDA: If I could just follow up the question Professor Pickering asked, just so that we are  
28 all on the same wavelength, because Professor Pickering had in mind exactly the point I had  
29 in mind in relation to the cost sharing. Could we look at the agreement between Albion and  
30 Shotton which is, I am told, is Annex 12 to Albion's Notice of Appeal.

31 THE PRESIDENT: Actually Annex 12 is the application for an inset appointment.

32 MR. VAJDA: Yes, that is right, it is in that Annex. If one goes to p.49 one has an agreement  
33 which is dated March 1999 between Albion and Shotton, and Professor Pickering I think

1 was referring and I want this to be confirmed with the witness, if we go to p.53, 7.4 of the  
2 Agreement.

3 THE PRESIDENT: Yes, that is right.

4 MR. VAJDA: The saving and the cost of supply net ... shall be shared between the customer and  
5 Albion 70:30. A. I seem to have removed it from my copy but I remember it, so I can  
6 manage. What is your point, Mr. Vajda?

7 MR. VAJDA: It is not a point, it is just so we all know what is happening here and this is the  
8 source of the 70:30. It is really in a sense confirmation.

9 THE PRESIDENT: Yes, we know this, Mr. Vajda.

10 MR. VAJDA: Yes.

11 THE PRESIDENT: How are we getting on?

12 MR. VAJDA: We are getting on – well, I have finished.

13 THE PRESIDENT: You have finished? (Laughter)

14 MR. VAJDA: I was going to leave you a little surprise. Subject to anything the Tribunal says but  
15 I am very happy, more than happy, to sit down.

16 THE PRESIDENT: You are happy to sit down, very well. Just stay there a moment, Dr. Brown,  
17 because your counsel may have some questions in re-examination. I am assuming nobody  
18 else wants to cross-examine? No.

19 Re-examined by Mr. THOMPSON:

20 Q Just very few questions, Dr. Bryan. The first, you may recall – it may seem a long time ago  
21 – you were asked about the relationship between CCV and MEA, and I think Mr. Vajda said  
22 he would take you to it, but I am not sure he ever did. If we could look at your witness  
23 statement, your fourth witness statement, para.98. In the middle there is a sentence  
24 starting “In the context of this case”? A. That is correct, yes.

25 Q “In the context of this case I believe that it is reasonable to equate CCV with gross MEA.”  
26 So that was your position as at 6<sup>th</sup> April when this statement was made. Is that right? A.  
27 That is correct, yes.

28 Q Then subsequently I think Mr. Jones swore a third statement, dated 10<sup>th</sup> May, some months  
29 later, and in the last sentence of para.9 he explains that the CCV represents “the  
30 accumulated capital expenditure on the asset in question adjusted for inflation.” So it  
31 represents the costs in real terms incurred in relation to the asset at the date of the analysis,  
32 and then he looks at the assumption you made. So that was the position in the light of Mr.  
33 Jones’s evidence.



1 Then, I think you gave evidence by reference to an Annex to Mr. Jones's first statement, is  
2 that right? CJ4 I think you referred to? A. The Asset Register entry?

3 Q Yes. It all went rather quickly, I just thought it might be helpful to clarify where that all  
4 came from. Am I right in thinking that p.2 of CJ4, table C11A, it has a left hand column  
5 "Gross MEA" is that right? A. That's correct.

6 Q And under category B, Group 2, there are water treatment works, is that right? A. That's  
7 correct.

8 Q I think you gave a figure of some 476 million. Is that the total of those treatment works?  
9 A. 476.3 I stand to be corrected on that, is I think the total for lines 3 to 10 of that table.

10 Q So the total figure for group water treatment works ---- A. Yes.

11 Q -- are given by Dŵr Cymru's figures? A. Yes.

12 Q So was your point that you could derive some idea of the MEA ----

13 MR. VAJDA: Do not lead the witness, please.

14 MR. THOMPSON: I am not seeking to lead the witness, I am seeking to clarify.

15 THE PRESIDENT: Just to put it slightly more neutrally, what inference do you draw from this  
16 table in terms of calculating the MEA?

17 MR. THOMPSON: Well we could go back to the transcript and see what Dr. Bryan said and ask  
18 him to explain by reference to this page, but ----- A. I think I can – I am certainly happy  
19 to explain my reasoning. We have here as the Tribunal will see a break down of MEA  
20 values for different categories of works. It may be of help to the Tribunal if I explain that  
21 "SW" as a prefix relates to surface water sources, and "GW" relates to ground water or  
22 borehole sources. The numbers following describe broadly speaking how complex the  
23 treatment process is at a particular works. Some good quality ground water sources need  
24 little or nothing but a whiff of chlorine, some require just a simple filter, others obviously  
25 require a lot more treatment.

26 First observation in response to Mr. Thompson's comments is that I refer back to Mr. Jones'  
27 comment that he has just taken us to which is that they do not keep MEA values as such and  
28 so one questions how it is possible to create this breakdown where MEA values are  
29 described to two decimal places. That is the first point. But in terms of what I did, I took  
30 the total MEA value and I contrasted that with the total amount of water that these treatment  
31 works produced. I then compared that with the CCV – the current cost value – that we have  
32 for our 10 works' sample at SA11 I think the reference was, and from that I was able to  
33 calculate that those 10 works represented 25 per cent. of output; that the total CC value of  
34 those 10 works according to Dŵr Cymru's evidence was 95.2 million. If output was the sole

1 dictator of the apportionment of these MEA values one would have expected it to be 119  
2 million. So it was on the low side, but it was not as low as Mr. Jones' evidence suggests it  
3 should have been, because Mr. Jones is saying the CCV for Ashgrove is 1.447 million, he  
4 accepts that. He is saying that the MEA value for Ashgrove is three and a quarter million,  
5 (well over twice) and indeed he should add in the cost of the sludge main, which is part of  
6 the treatment plant, but clearly not part of the water distribution system, and that would  
7 bring it up to three and a half million.

8 So what I did, and the reason why I took that view that CCV was the only value that we  
9 have relating to Ashgrove, the reason why I was reasonably confident that that was a  
10 reasonable proxy for MEA was because of that analysis. I fully accept that it is likely to be  
11 slightly low given the analysis that I have just described. My belief is that that would result  
12 – were one to apply a correction factor – that would result in a revised MEA true, if you  
13 like, MEA for Ashgrove of £1.815 million – some £300,000/£400,000 more than my  
14 estimate but some considerably lower than Mr. Jones.

15 Q Can I now ask you something about the stand-alone MEA question. You were given  
16 various analogies of Mr. Vajda buying a car for, I think, £20,000 . I would like you to  
17 imagine that if Mr. Vajda needed a car to drive himself to the station and for nothing else –  
18 so, for example, a second hand Honda which might cost, say, £8,000, but he spent, say,  
19 perhaps £20,000 on a smarter car, or perhaps splashed out and paid £40,000 for a Range  
20 Rover because he thought it would look smarter, which would be the correct MEA value for  
21 these purposes? Would it be £8,000, £20,000 or £40,000? A. My understanding is that  
22 to fulfil the necessary functionality of taking Mr. Vajda from his home to the station the  
23 banger would do, would suffice, that would be the most efficient way of ensuring that  
24 functionality. But I have a more profound misgiving about that approach, which is that  
25 OFWAT would not allow that approach in tariff setting. It could not possibly allow that  
26 approach because we would end up with tariffs that reflected a hypothetical new water  
27 industry rather than the reality which is that we have a water industry that is still heavily  
28 dependent on the investment of our Victorian forebears, let alone pipelines like this that  
29 were put in in the 50s. So, notwithstanding the OFT reference that we have been pointed to  
30 and I claim no expertise in that area, that is not the way that tariffs are set or justified within  
31 the water industry.

32 THE PRESIDENT: You do not justify the tariff on the basis of new build costs? A. There is  
33 an element within any tariff setting proposal that reflects the forward looking capital  
34 programme, in other words, what that particular water company has to do to fulfil its

1 obligations through the next five year period or whatever it is that OFWAT chooses as the  
2 timescale for the tariff setting. But absolutely no way is it based on an assumption that all  
3 assets will be replaced willy-nilly.

4 MR. THOMPSON: The third and final area I wanted to just touch on is the different in pipeline  
5 costs. You will recall that the President asked a question about how it was that such a large  
6 difference arose. Could you open the second witness statement of Mr. Jones? It is Annex 2  
7 para.6. A. Yes.

8 Q Can you explain how Mr. Jones appears to have reached his total MEA value for the  
9 pipeline? A. Well he has used a table which is familiar from my witness statement,  
10 where Mr. Vajda took me through how I would approach it.

11 THE PRESIDENT: You reproduce it. A. And I took that from this very table for consistency's  
12 sake. Mr. Jones has used the length that has taken from what he says was a desk top survey,  
13 16.5 kms, and then he has applied unit costs that reflect Dŵr Cymru's unit cost provided for  
14 the 1999 periodic review, which I have challenged as excessive, to create a basic cost of  
15 £6.745 million, and he has then added to that the additional costs that would be incurred for  
16 different circumstances and those he split into pipes going through rural and suburban  
17 areas, a rather long length going through urban areas which I disagree with but which I have  
18 used in my worked example to be consistent, and then the river crossing and railway  
19 crossing where he has assigned additional unit costs, additional that is to the £408 per metre,  
20 and he has added those together to create his total of something a little short of £8 million.  
21 He has then indexed that, he has inflated that by a factor of 13.9 per cent. to give an outturn  
22 cost of something over £9 million.

23 MR. THOMPSON: Yes, and if we then take your analysis, which I think is Annex B to your  
24 statement, paras. 81 and 82, while keeping Mr. Jones's open, the figures are not the same in  
25 your 81, that is because you have done the 13.9 per cent. inflation? A. I have done two  
26 things there, Mr. Thompson. I have added in the 13.9 per cent. to the table in Mr. Jones's  
27 statement that you have referred to, and I have added in, as you will see the sludge main,  
28 which I believe to be ----- In fact, Mr. Jones also comes to the sludge main a little bit later  
29 on in his own statement.

30 Q Looking at your 82, quite markedly different figures are produced. Then, in 83, somewhat  
31 lower. I think it is in your statement, but could you explain in general terms why you think  
32 the basic figure Mr. Jones has used is much too high?

33 THE PRESIDENT: I think, if I may just make a supplementary to that before you answer, Dr.  
34 Bryan, one question is why you have preferred 176 as your basic cost to 465, which is Dwr

1 Cymru's basic cost? A. Yes. Well, that 465 is, I believe – and, again, I stand to be  
2 corrected – Mr. Jones' extrapolation of the cost of a 700 millimetre main based on Dwr  
3 Cymru's unit costs for the 1999 periodic review. I say in my witness statement that those  
4 costs appear to be excessive as they stand. They are significantly higher than the OFWAT  
5 benchmark unit costs. Therefore, I have preferred to use the OFWAT benchmark unit costs  
6 as a more reliable measure, and a measure that is, indeed, more consistent with figures that  
7 come after it. I have also assumed a 600 millimetre plastic pipe. So, I have not needed to  
8 extrapolate those figures to 700 millimetres. Hence I end up with a figure of 176. The  
9 workings for that should be within the body of that witness statement.

10 Q Why do you assume 600 millimetres as distinct from what we understand the present pipe to  
11 be, which is 700 millimetres? A. Because 600 millimetres is a more effective way of  
12 achieving the same functionality fundamentally. A. What we have in the Ashgrove  
13 system at the moment is a 700 millimetre steel pipeline that was put in in the mid-1950s. It  
14 is exactly the same sort of pipeline that was put in to supply Bretton Works. We know that  
15 that pipeline delivers the requisite volume. What I have done is assessed, as best I can,  
16 whether it would be possible to achieve the same functionality with a smaller pipe. I have a  
17 vested interest in doing so – it reduces costs and clearly pipe insertion is not possible.  
18 Technically it might be, but for the simple issue here, it is not possible to put a 700  
19 millimetre pipe through a 700 millimetre pipe without bursting the pipe, which is an  
20 altogether different technology. So, what I did was that I assessed whether a 600  
21 millimetre polyethylene pipe (a plastic pipe) would give us the same ---- the required  
22 functionality as the current 700 millimetre pipe does. I have concluded that it would, and  
23 hence I have used that as the basis for my calculation.

24 MR. THOMPSON: Those are the only questions I have by way of re-examination of Dr. Bryan.

25 PROFESSOR PICKERING: Dr. Bryan, could I just ask you about technical progress in this  
26 industry? I just wonder whether, in terms of the production, treatment and distribution of  
27 water, you feel there is sufficient technical progress, or are we still operating on the  
28 technologies of, say, twenty years ago? I think you have just referred to 'new materials' or  
29 'different materials'. Setting aside the question of price movements in the same materials,  
30 are there significant elements of technical progress? A. There is some, sir, at the  
31 margins, but this is an industry which has gone in phases. If you do not mind me taking a  
32 couple of minutes ----? The water industry responds to major challenges – or has done in  
33 the past. The first major challenge was the cholera outbreaks that hit London, in particular,  
34 in the 1840s and 1850s. Those gave rise to the water networks, the water distribution

1 systems that we have today in large measure in our urban areas. Hence, Thames Water  
2 complaining that many of its pipes are 150 years old. The next major change was the  
3 introduction of chlorination as a disinfection agent which took place in the early 1900s.  
4 Again, that was a profound change. At the same sort of time, for those of you who know  
5 London, the Metropolitan Water Board was making huge investments in the reservoirs that  
6 one sees in the Thames Valley, near Heathrow, and, to a lesser extent, in the Lee Valley to  
7 the north. The same was happening with Birmingham, and with other major conurbations  
8 looking to supply water supplies.

9 Since then, yes, there have been changes at the margins. Yes, we can point to reverse  
10 osmosis, for example, which is what Albion introduced at Hammersmith Hospital and what  
11 Thames are proposing for their desalination plant. One can look at ozone that in some  
12 respects can replace chlorine. One can look at certain improvements in treatment  
13 technologies. But, those are at the margins. It is a generalisation, but no less true for that,  
14 that the water industry has rested on its laurels not for the last twenty years, but really for  
15 the last fifty to sixty years. Much of what one sees in the systems as one goes around  
16 would be immediately familiar to our Edwardian forebears – and, indeed, in many cases, to  
17 our Victorian ones.

18 There has been very little pressure on the industry to innovate. The regulatory regime that  
19 we have had since privatisation has been about improving what we currently have –  
20 incremental benefits; incremental efficiency improvements on the existing model. There is  
21 very little incentive within that structure to innovate; to break out and to do something  
22 completely different.

23 Q Would competition create significant innovation, and, if so, in what ways? A. In my  
24 mind it would create very significant and desperately needed innovation. It would create  
25 innovation in a number of ways. As the Tribunal – though not this panel – is aware, we  
26 have been involved in an attempt to introduce competition into the domestic sector. It is the  
27 domestic sector where innovation is going to have the most profound effect.

28 THE PRESIDENT: What sort of innovation are we talking about? A. We are talking about  
29 recognising that ---- If one accepts the figures that are currently published, the average man,  
30 woman and child in this country uses 160 litres of water a day. Some would say 150. The  
31 reality is that that figure is a guess. That figure is what remains after we make certain  
32 assumptions about leakage. The studies on which that figure is based are poor at best. Our  
33 own view is that not only is that 160 litres unnecessary, but it is clear to everyone who has  
34 turned on a tap that most of that water does not need to be potable. So, I think when one

1 looks at the industry in the future we will see people using less water – not by cleaning their  
2 teeth out of a mug, but by using more efficient devices (in other words, no reduction in the  
3 quality of service they receive), and also by using appropriate grades of water. So, in our  
4 BedZed exercise which was described to the Tribunal in the Albion Yard bathhouse case ---  
5 - in that particular case we recognised that we could treat waste waters and return them to  
6 the customer as a water that was entirely suitable for toilet flushing and for garden  
7 irrigation. When one considers that the real problems we get in summer tend to be the peak  
8 demand problems occasioned by garden watering, one can start to see how those  
9 innovations can take effect. Now, they will not take effect across the board. They will take  
10 effect by targeting new developments and redevelopments, and making sure that the  
11 housing stock that we create for the future is much better in terms of its acknowledgement  
12 of the importance of water use efficiency than the housing stock that we have been building  
13 for the last hundred years.

14 THE PRESIDENT: I have just one question, Dr. Bryan, if I can take you back more to the  
15 technicalities of this particular case for a moment. It is our old friend the potable/non-  
16 potable comparison. In parts of the argument as it is now being developed, it is said that  
17 what one should really look at is the bulk part of the potable system and compare that with  
18 bulk non-potable. A. Yes.

19 Q We know, however, that the bulk part of the potable system is actually part of a larger  
20 whole which delivers everything to all sorts of customers. I am just wondering if you have  
21 got any comment on that approach – and, in particular, whether in your view that approach  
22 compares like with like? A. I think to answer that, one has to go back to Dwr Cymru’s  
23 justification for the large industrial tariff that we have considered indeed at the previous  
24 hearing. I do not find any particular problem with the way that they have dealt with  
25 generating that large industrial tariff. One could quibble about some of the cost allocations  
26 at the detailed level, but, in essence, what Dwr Cymru said to the Authority, and what the  
27 Authority accepted, was that there are different costs associated with different components  
28 of the distribution system, and, if you like, a hierarchy approach where the very large mains  
29 were at the top, and the very small mains were at the bottom. What Dwr Cymru argued –  
30 and I take no issue with that – is that the largest customers use only the top tier of assets  
31 whereas the domestic customers use all tiers of assets. If one can attribute costs to those  
32 various tiers, then depending which tiers the customer in question – or, one should say, the  
33 class of customer currently in question uses – then one can create a tariff structure which is

1 broadly cost reflective. I have no issue with that at all. I have no issue with Dwr Cymru's  
2 recognition that that top tier is 16p, give or take. So, that I am quite happy with.

3 Where I remain entirely unconvinced is that that top tier is at all suitable as a proxy by way  
4 of physical description or indeed cost to the non-potable systems that we no have more  
5 details on.

6 Q I think that completes your evidence, sir.

7 (The witness withdrew)

8  
9 MR. ANDERSON: Sir, our witness, Mr. Paul Hope - I understand that both Mr. O'Reilly and  
10 Mr. Thompson wish to ask questions – is unavailable tomorrow because he has a hospital  
11 appointment.

12 THE PRESIDENT: You still have an opening statement to make, which you ought to make at  
13 some point – if you wish to.

14 MR. ANDERSON: I was not planning to now, since we have started the evidence. I have put in  
15 such full written submissions, that I was planning just to have one go. I do have some  
16 questions for Mr. Jeffery, but, again, that will be quite short because it covers ground that  
17 Mr. Vajda covered with Dr. Bryan on the retail services, and so on. So, I was not planning  
18 to be very long on Mr. Jeffery. I was not planning to spend any time with Mr. Jones.

19 THE PRESIDENT: So, if we say, in terms of order of witnesses now, Mr. Jeffery, and then  
20 perhaps interpose Mr. Hope, and then get on to Mr. Jones ---- Is that a sensible way of  
21 doing it? Is that satisfactory?

22 MR. VAJDA: Mr. Jones is a busy man. He would like to get away today.

23 THE PRESIDENT: Let us see how we get on, Mr. Vajda. You have taken quite a lot of time  
24 now, and we will just have to do the best we can.

25 (Short adjournment)

26 MR. THOMPSON: As I understand it, it is now Mr. Jeffery.

27 Mr. MALCOLM JEFFERY, Called

28 Examined by Mr. THOMPSON:

29 Q Mr. Jeffery, do you have the Albion Reply bundle? I will put it another way, do you have a  
30 statement sworn by you in November 2004? A. I do.

31 Q I think it appears in the papers as tab 3 to the Reply bundle. Can you state your full name  
32 and address and your role in this matter? A. Certainly. My name is Malcolm Jeffery. I  
33 live at 57 Antrim Road, Woodley in Berkshire, and I am the Director of Albion Water and  
34 of its parent company, Water Level Limited.

1 Q I believe you have sworn two statements in this matter, and the first is the one I have just  
2 referred to, which is a statement of some four pages and signed by you, I think, on 7<sup>th</sup>  
3 November 2004. Is that correct? A. I have 9<sup>th</sup> on my copy.

4 Q I am sorry, I mis-read that. Then more recently, do you have the bundle which includes also  
5 Dr. Bryan's statement, or do you have it loose-leaf – in my version it is tab 9 – which also  
6 has Dr. Bryan's statement, but it is a statement dated 19<sup>th</sup> April 2006. Is that right? A. I  
7 have it as loose-leaf., and I confess that my copy is undated, but it is headed "Second  
8 witness statement of Malcolm Jeffery".

9 Q Yes, and it goes through to 13 pages, the last page being the statement of truth? A. That  
10 is correct, with a number of attachments.

11 Q Is this your evidence in this matter? A. It is.

12 Q Is it true to the best of our knowledge and belief? A. To the best of my knowledge and  
13 belief it is true.

14 Q I believe that Mr. Anderson has some questions for you. A. So I understand.

15 Cross-examined by Mr. ANDERSON:

16 Q Good afternoon. A. Good afternoon, Mr. Anderson.

17 Q Could I ask you to turn to the first of your two witness statements, please, Mr. Jeffery.

18 MR. THOMPSON: Sir, I do not want to delay things but Mr. Anderson was not here yesterday  
19 and I did make the point that this is now a year after a hearing at which Mr. Anderson was  
20 perfectly entitled to cross-examine, and I simply register the fact that it seems curious that  
21 he ----

22 THE PRESIDENT: Well let us see how we get on.

23 MR. ANDERSON: I am not going to be very long. (To the witness) If you could turn to the last  
24 page of that witness statement there is a little table which summarises where you get to at  
25 the end of the figures and calculations that proceed that. You conclude that you believe that  
26 analysis supports the view that a reasonably efficient retailer will require a margin between  
27 wholesale and retail prices of 5p per m<sup>3</sup>, which his about £340,000 per annum.? A. Yes,  
28 that is correct.

29 Q If I could ask you to look at Dr. Bryan's witness statement of 7<sup>th</sup> April, Annex A. A. I am  
30 sorry I do not have that in front of me.

31 THE PRESIDENT: This is Dr. Bryan's latest witness statement of 7<sup>th</sup> April 2006.

32 MR. ANDERSON: JB4, Annex A, and turn to p.42 of that, para.164. Dr. Bryan is discussing the  
33 customer service costs for both Shotton and Corus and he concludes: "I therefore consider



1 that the customer service costs for the Ashgrove system should be no more than £20,000 per  
2 year.” A. Yes.

3 Q Or £10,000 per customer that would be. How do you explain the difference between the  
4 figure of £340,000 that you have identified as retail margin and that figure of £10,000 per  
5 annum for customer service costs? A. I did not prepare Dr. Bryan’s witness statement,  
6 but my understanding is that his figure of £20,000 represents an apportionment of the costs  
7 he believes that Dŵr Cymru allocate. Or as my figure is perhaps under described as  
8 “retailer” and it comprises the cost of all of the activities that are carried out on behalf of  
9 Shotton Paper which, as Dr. Bryan explained before lunch, comprise a comprehensive range  
10 of services including the carrying out of statutory responsibilities under the Water Industry  
11 Act, the provision of a retail function and not the least the carrying out of a number of  
12 activities which have been described variously as technical advice, consulting, but which do  
13 embrace an element of our responsibilities under the Water Industry Act for conservation of  
14 water.

15 Q The technical consultancy activities that Dr. Bryan was explaining in answer to Professor  
16 Pickering and Mr. Vajda. Is that right? A. Yes I would describe them as water use  
17 efficiency, or water conservation issues, and I think it is arguable whether they are wholly  
18 technical advice, wholly consultancy, or wholly Water Industry Act responsibilities, and I  
19 think one could argue that these activities have a foot in each camp, as it were.

20 Q Who was providing them in 2001 – Albion or Envirologic? A. Albion was responsible  
21 for the provision of regulated services to Shotton Paper. Albion at that time, and it is still  
22 the case, has no direct employees and the services are provided from personnel employed in  
23 the parent company.

24 Q Right, so when Albion wrote the letter of 24<sup>th</sup> April that I hope is somewhere before you,  
25 Dr. Bryan was looking at it earlier. The Authority asked you to supply further documents  
26 and you, your company, replied that you did not think that it was appropriate but in a spirit  
27 of co-operation? A. Yes, that is correct. The reason for our puzzlement, I think, was that  
28 we thought this width of margin squeeze, and I think we thought that had been dealt with in  
29 the interim Judgment at para.413, which was that the services that we provide as a licensed  
30 undertaker and as a retailer were a given, and that there should be margin attaching to those.

31 Q I understand your case, Mr. Jeffery, that is not what I am asking you. I am just asking, you  
32 are familiar with this letter, and you are obviously from your description involved in the  
33 preparation of it. You say in para.2: “We currently provide no non-regulated services for  
34 Shotton Paper, although Envirologic did provide some consultancy services prior to May

1 2003. I am interested in what those consultancy services that Envirologic provided were?  
2 A. I believe those were the services to which Dr. Bryan referred this morning.  
3 Q So provided by Envirologic? A. Yes.  
4 Q And Envirologic is not, and never has been, a regulated water undertaker? A. That is  
5 correct.  
6 Q And so in a sense the person, the company that provided this technical consultancy could  
7 not have provided regulated water undertaking activities, because it was Envirologic? A.  
8 In the case of the services that Dr. Bryan referred to this morning, that is the case, yes.  
9 Q Which he described as “the most significant services” being provided? A. I think we may  
10 be talking about two different things. I am talking about the consultancy services provided  
11 prior to May 2003, and I look to Dr. Bryan to correct me if I have misinterpreted, but I think  
12 what he was saying, the services he was referring to there, were the services that arose from  
13 a share of savings agreement that Envirologic had with Shotton Paper.  
14 Q A 70:30 split? A. No, it preceded that, and---  
15 Q A 50:50 split? A. – and it related to the reduction in the bulk supply price, so the 50:50,  
16 yes.  
17 THE PRESIDENT: As a separate agreement with Envirologic, as distinct with the supply  
18 agreement we have with Albion?  
19 MR. THOMPSON: Sir, I hesitate to get up, but the fact is Dr. Bryan is here and he knows about  
20 all this ----  
21 THE PRESIDENT: It is a bit difficult, it is a pity that in some ways the author of the letter is not  
22 being asked about this, Mr. Anderson.  
23 MR. ANDERSON: Well it was simply because Mr. Jeffery had described these activities in his  
24 first witness statement, and annexed all the letters to it. But I wonder, could you help me  
25 with the 2001 accounts, then? Are you familiar with those?  
26 THE PRESIDENT: Are we leaving this point and going to another point?  
27 MR. ANDERSON: It is a related point. But if the Tribunal thinks it is sensible to recall Dr.  
28 Bryan, then fine.  
29 THE PRESIDENT: Well let us see how we get on, Mr. Anderson. A. I will help you as much  
30 as I can, but I was not finance director for either Water Level or Albion Water at the time,  
31 and I was not responsible for the production of the accounts, but I will help you as much as  
32 I can.  
33 MR. ANDERSON: Well see how far you can get.  
34 THE PRESIDENT: Where do we find these, Mr. Anderson?

1 MR. ANDERSON: Well I am not sure where they are in the voluminous papers , but they are ----  
2 THE PRESIDENT: Perhaps you could help us a little, or somebody in your team could help us as  
3 to where we could find them.  
4 MR. ANDERSON: I have two copies here, but that is the only number of copies that I have been  
5 able to find today.  
6 THE PRESIDENT: Are they in our papers?  
7 MR. ANDERSON: I am not sure if they are in your papers.  
8 MR. THOMPSON: I am afraid I have no idea what Mr. Anderson is talking about?  
9 THE PRESIDENT: Apparently it is the 2001 accounts. We would like the documents available  
10 for the Tribunal if the witness is going to be asked about them.  
11 MR. THOMPSON: Certainly. Would the Tribunal bear with me on an undertaking to provide  
12 further copies – one copy for the Tribunal and one copy for the witness at this stage.  
13 THE PRESIDENT: Right, well let us see how we get on. (Document handed to the Tribunal and  
14 the witness)  
15 MR. THOMPSON: As I understand it these accounts were signed by Dr. Bryan, and Mr. Jeffery  
16 does not know anything about it. A. They are actually signed by Mr. Woodyear, who  
17 was Company Secretary for Envirollogic at the time.  
18 THE PRESIDENT: They are also signed, there is a signature from Dr. Bryan on the document,  
19 right. You may again, Mr. Anderson, not be directing your fire for the right witness, but let  
20 us see how we get on.  
21 MR. ANDERSON: I may not be, but if I could ask you to turn first to the Envirollogic  
22 consolidation Profit & Loss account at p.4, 2001, turnover, costs of sales, gross profit and  
23 administrative expenses. Again if you cannot help me, you cannot help me, but would that  
24 figure of £730,000 include the cost of these consultancy services? A. Which consultancy  
25 services do you mean?  
26 Q The ones that we have just been talking about that led to the 50:50 split? A. No. No, they  
27 would not.  
28 Q Why is that? Where would we find them? A. They pre-date ---- They were several  
29 years ahead of this. In fact, they pre-dated the inset appointment.  
30 Q Right. Well, would we then expect to find in the consolidated profit and loss account of  
31 Albion the costs of the technical consultancy services that he was describing in the witness  
32 box that post-dated that? He described as part that he regarded as being regulate activities.  
33 A. Yes. They would be included in the profit and loss account for Albion Water.

1 Q So, let us turn to the profit and loss account of Albion Water which is next in the field. At  
2 p.4 – administrative expenses. £30,000 in that case. Presumably that £30,000 is the cost of  
3 providing these technical consultancy services. A. Amongst other things, yes.

4 Q So, the £30,000 includes more, does it? A. The activities that Albion was carrying out  
5 at that time were the range of activities which I have previously described.

6 Q As a regulated undertaker, they have to include in their accounts the cost of providing those  
7 services. Is there anywhere on that page, other than the £30,000, that we will find those  
8 costs? A. Nowhere else on that page.

9 Q Anywhere else anywhere else in the document?

10 MR. THOMPSON: I think this is terribly unfair. I have not seen any of these documents. Mr.  
11 Jeffery was not the author of any of these documents. He is simply being asked to speculate  
12 about some accounts – and there is a witness here who the Director did not choose to cross-  
13 examine on this issue. These are events going back five or six years, and in relation to a  
14 witness statement that was sworn eighteen months ago, and which any of these points could  
15 have been taken at the last hearing. I have to say, I cannot imagine why this has not been  
16 raised in advance.

17 THE PRESIDENT: I think you will have to put these points ----

18 MR. ANDERSON: It has been raised in advance. We wrote two letters seeking clarification of  
19 these points, and got the letters back ----

20 THE PRESIDENT: You will have to put these points to Dr. Bryan, Mr. Anderson. You can  
21 continue putting them to Mr. Jeffery, but insofar as he is not able to help because he was not  
22 responsible for these documents, I think you have to put them to the person who signed the  
23 document.

24 MR. ANDERSON: I have a few more questions for Mr. Jeffery. If the Tribunal would permit  
25 me to recall Dr. Bryan. He has heard this. It maybe he can shed light on this. (To the  
26 witness): Going back, this includes the 339,000. We looked at para. 8 which describes how  
27 the figures are made up – paras. 8 and 9. What precisely is included in the water  
28 management and provision of detailed water data in para. 9? A. That is understanding  
29 the daily/monthly/yearly, and perhaps many years into the future, water needs of the  
30 customer, including what I would regard as commercially sensitive information about both  
31 volume of production and water use. Reflecting that in advice to Shotton Paper  
32 Management on what is possible and what is not; what the implications are for water supply  
33 to their premises; and what the cost implications of that might be if it disturbs the present  
34 arrangements; looking at the sorts of things that Dr. Bryan was talking about before lunch,

1 which are the micro-management of water as opposed to the macro-management of water as  
2 a water undertaker. But, it will also include, for example, in the same way that our  
3 employees go through an induction programme to be trained to be safe on site at Shotton  
4 Paper, their management and their new employees assigned to that site have some, what I  
5 would call, induction training from us about the water supply system.

6 Q These are Shotton employees getting induction training from you. A. When necessary,  
7 we explain to them how the water supply system works; what it means; what it means for  
8 them on site. Where they express an interest in up-stream facilities, we actually describe  
9 what those facilities are and how they work.

10 Q Does that also involve advising on the system within the Shotton site? A. It does.

11 Q And the distribution of water throughout the Shotton site for their industrial process? A.  
12 Yes, although that is partly covered under (b) ----

13 Q Advice on water use efficiency. A. Yes.

14 Q 'Drinking water quality compliance' is obviously potable water. A. Yes.

15 Q 'Leakage studies' are not carried out. 'Compliance with statutory responsibilities' you then  
16 set out in Annex 1. I am not proposing to ask the witness each of those because we dealt  
17 with that in some detail in Annex 3 to our reply. (After a pause): I wonder if you could  
18 explain two sentences in the latest skeleton argument from Albion.

19 THE PRESIDENT: Do you mean the very last submissions we have just had – 26 May?

20 MR. ANDERSON: I do, sir. (To the witness): It is just the apparent difference between  
21 paras. 39 and 42. It is the second sentence of para. 39. "Secondly, and of specific  
22 importance in this case, by following the way in which Albion discharges those  
23 responsibilities [the sorts of responsibilities you have been talking about] makes the service  
24 distinct from that previously provided by Dwr Cymru to Shotton Paper and from that  
25 currently provided by Dwr Cymru to other large users eligible for additional services."  
26 Then, in para. 42 ----- A. I am not sure I am in the same place as you, Mr. Anderson,  
27 but I do recall the paragraph.

28 Q I am para. 39. The second sentence. A. I have that.

29 Q Then, in para. 40(2), "This level of performance [which I think is now talking about  
30 Albion] is achieved by fully understanding the customer's business practices and processes  
31 by building the customer's trust over an extended period and by acting in partnership. To  
32 the best of our knowledge this level of service has not been replicated anywhere else in Dwr  
33 Cymru's area". A. Yes.

1 Q I am sorry. I read the wrong sentence in para. 39. I meant the first sentence, “Albion  
2 would go further, firstly by confirming that the nature of the service it provides to the  
3 customer are similar, if not identical, to those provided by all statutory undertakers”. So,  
4 what is the difference between the level of service you are describing in para. 39 which is  
5 similar, if not identical, to those provided by all statutory undertakers and the level of  
6 service described in para. 42 which seems to suggest it is a unique level of service, not  
7 replicated anywhere else in Welsh’s statutory area? A. I think it is because in the first  
8 sentence of para. 39 I used the word ‘nature’ rather than ‘level’. I think the things we do  
9 are governed by statute, by our license, and by our customer agreement. The way we do  
10 them is remarkably different from other people, as the Tribunal has heard this morning.

11 Q In what way specifically? A. Well, I don’t know of another water company that acts in  
12 partnership with a customer, and whose attention to customer relations matches ours.

13 Q So, it is this partnership with Shotton where you have a dedicated person who goes in on  
14 site and, as I understand it, only operates for the benefit of Shotton, for the benefit of this  
15 partnership, and understands the business and advises on ways to save water consumption.

16 A. Yes. I think for this size ---- It is an opinion, but I think for this size customer and this  
17 volume of water use, that reflects what we believe to be our responsibilities in terms of  
18 water conservation, but it also reflects the way we think we ought to deal with such a large  
19 customer.

20 Q I see. Are you familiar with the agreement between your company and Shotton? A.  
21 Yes.

22 Q You are. Perhaps we could just have a very brief look at that finally? You will find it at the  
23 back of the original Notice of Appeal – at about p.53, I think. It starts at p.49. I just  
24 wanted to ask you one or two points of clarification on the terms of this.

25 THE PRESIDENT: Is it not better to put these to Dr. Bryan, Mr. Anderson, who made the  
26 agreement?

27 MR. ANDERSON: Yes, sir. As I say, the only reason I am asking is because it was Mr. Jeffery  
28 who put in the witness statement describing in detail the nature of the services that were  
29 said to be provided. We did seek clarification and did not get it. Perhaps I should have  
30 asked them to Dr. Bryan.

31 THE PRESIDENT: Let us see what Mr. Jeffery said. (To the witness): When did you join the  
32 company, Mr. Jeffery? Were you around in 1999? A. Yes, I was, sir.

33 MR. ANDERSON: Clause 7 – “Albion Water is a water undertaker licensed by OFWAT, has  
34 legal obligations and legal responsibilities under the Water Industry Act. Its responsibilities

1 include those imposed by the statutory system of economic regulation and administration in  
2 England and Wales.” In para.7.4 there is a description of using Albion’s reasonable  
3 endeavours to provide the customer with the most cost effective source of water. That is not  
4 the sort of statutory obligation you are referring to in 7.1 is it, or the agreement is referring  
5 to? That is an additional service, yes? A. Bear with me for a moment, Mr. Anderson?

6 Q Of course. A. Yes, I would say one could operate this inset appointment on the basis of  
7 7.1 alone, but it is unlikely that one will be able to do that without a margin for very long,  
8 so 7.4 is an optional extra, if you like.

9 Q 7.4 is an optional extra and the way in which it is envisaged that you will be remunerated  
10 for that is by the 70:30 split? A. That is correct.

11 Q How do you plan to be remunerated for the activities identified in 7.5? A. I think it says  
12 clearly that they will be provided as part of Albion Water’s remit, it is an obligation to the  
13 customer that we would have to meet.

14 Q So those fall into a slightly different category to the 7.4 obligations? A. Yes.

15 Q I see. Those are all my questions for Mr. Jeffery. I am very grateful to you.

16 THE PRESIDENT: Anything in re-examination, Mr. Thompson? We need to go back and sort  
17 out this question on the accounts.

18 Re-examined by Mr. THOMPSON:

19 Q For clarification, it went quite quickly, but I think Mr. Anderson referred to Annex 3 to I  
20 think it was the skeleton argument of the Director in the hearing last year, where various  
21 comments were made about Annex 1 to your first witness statement. Do you remember that  
22 issue? A. I recall it, yes.

23 Q I do not know whether Annex 3 can be provided?

24 THE PRESIDENT: What are we looking for? We are looking for Annex 3 to the ----

25 MR. THOMPSON: It is the skeleton argument of the Director, or the Authority for the last  
26 hearing. It is p.81 to the skeleton, the Annex runs on.

27 THE PRESIDENT: Yes.

28 MR. THOMPSON: It is quite a short point, Mr. Jeffery, I do not know whether you have it in  
29 front of you, but ---- A. I do.

30 Q The point was that various criticisms were made of Annex 1 and, in particular, for example,  
31 para.4 states: “The numbering of the sections in Annex 1 to Malcolm Jeffery’s witness  
32 statement appears to be wrong. It may be that Annex 1 is based on an earlier version of the  
33 Water Bill rather than the Act itself. This would explain the use of the term “clause”. I  
34 believe that you can clarify the position of Annex 1, and it may be appropriate for the record

1 for you to do that, the Annex 1 to your statement and what it is? A. Yes, I am happy to  
2 do so, it is a document which, for convenience, was reproduced from legal advice provided  
3 by, as it happens, a former employer, the legal department, that related to the anticipated  
4 duties and responsibilities under the then pending Water Bill.

5 Q So it does not purport to be the actual Bill itself, it was a document available to you, is that  
6 right? A. It was a document available to me, and it was distributed to Envirollogic's  
7 relevant employees on the basis that "This is the sort of advice that is provided by Statutory  
8 Water Undertakers in circumstances of this kind. You guys need to be aware there are those  
9 sorts of responsibilities attaching to an inset appointment, and to the extent that they are  
10 relevant to your post you will need to be aware that there is legislation and address yourself  
11 to it."

12 Q Yes. That was the only point of clarification just for the Tribunal.

13 THE PRESIDENT: Thank you very much, Mr. Jeffery.

14 MR. THOMPSON: I am not sure whether Dr. Bryan is required again or not?

15 THE PRESIDENT: Well let us see. The point that is being made, or was put, I think – Mr.

16 Anderson will correct me if I get it wrong, is that in Mr. Jeffery's witness statement there is  
17 a figure of £330,000-odd as the retail margin he says in his evidence is necessary and there  
18 is a figure for administrative expenses in Albion's accounts for the year ending 31<sup>st</sup> March  
19 2001 which is some £30,000, and the only question in my mind is whether that point, if it is  
20 a point that is pursued, should be put to Dr. Bryan, who signed the accounts in question. I  
21 have a feeling that it should.

22 MR. THOMPSON: I am sure he is in much the best position of anyone in this room.

23 THE PRESIDENT: So thank you, Mr. Jeffery, you stand down, and we will just as Dr. Bryan to  
24 come into the witness box again. Sorry to put you to that trouble, Dr. Bryan, and invite Mr.  
25 Anderson to put the question to you, if you would be so kind.

26 (The witness withdrew)

27 Dr. JEREMY BRYAN, recalled

28 Further cross-examined by Mr. ANDERSON:

29 Q Thank you. I am sorry to trouble you? A. It is no problem, Mr. Anderson.

30 Q The point has been put fairly well by the President, in the accounts for 31<sup>st</sup> March 2001 we  
31 find for Envirollogic an administrative expenses figure of £730,000 and for the same year for  
32 Albion we find an administrative expenses figure of £30,000. That is on p.4, I think, of  
33 each set of accounts.



1 THE PRESIDENT: Have you got the document, Dr. Bryan? A. I have, Sir. Let me just turn  
2 up Albion.

3 Q Albion is towards the back and it is p.4 of the stuff at the back. A. I am with you.

4 MR. ANDERSON: What is troubling me at the moment is reconciling that figure of  
5 administrative expenses of £30,000 for Albion with the retail margin that you are  
6 contending, or Mr. Jeffery is contending is a reasonable retail margin that comes to some  
7 £340,000? A. Indeed. I am more than happy to explain it. Let me reiterate what Mr.  
8 Jeffery said which was when we are talking about retail margin you are talking about the  
9 totality of costs incurred by Albion in fulfilling its functions, not all of which would be  
10 recognised as retail administrative expense, but let us have in mind the figure of £300,000.  
11 If you turn to the Albion accounts, there are two things I wish to draw your attention to.  
12 First the gross profit figure, you will see there is turnover of 1.7 million in 2000 and one  
13 slight increase over the turnover figure in 2000 and you will see that the cost of sales  
14 results in a very small gross profit. That gross profit would have been zero had it not been  
15 for slight indexation changes in the way that the contracts work. In other words, we were  
16 making a small amount of profit in the few months between indexation changes, that gives  
17 us that figure of £29,800.

18 The second figure I would draw your attention to is the profit figure of the bottom line,  
19 which is zero. The problem that Albion had and there was never any attempt to hide this  
20 from the Authority, was that Albion was unable, as a stand-alone organisation, to sustain  
21 itself at that time. It was suffering margin squeeze. The consequence was that in order to  
22 maintain our licence we had to demonstrate to the Authority that we could continue trading,  
23 and therefore the maximum costs, administrative expenses, that we could charge against  
24 those accounts was £30,000 which resulted in a nil profit figure, and a continuation of  
25 Albion as an ongoing concern. The risk was borne entirely by Envirollogic and so the full  
26 cost, the difference if you will between £30,000 and Mr. Jeffery's figure of £300,000 is in  
27 the Envirollogic accounts. That commercial risk, while we were fighting a legal battle  
28 against Dŵr Cymru and at that stage the Authority itself, that commercial risk was carried  
29 by Envirollogic with the full knowledge of the Authority and obviously with the full support  
30 of Pennan, who were at that point our joint venture partners, and who were providing the  
31 finance to allow us to continue.

32 Q You say with the full knowledge of the Authority, are you saying that some of the  
33 administrative expenses associated with the retail activities and statutory obligations that

1 Mr. Jeffery has explained at some length in his first witness statement appear in  
2 Envirologic's accounts but not therefore in Albion's? A. At that date, yes.

3 Q And so this £30,000 is a construct arriving out of the fact that the operating profit, the gross  
4 profit is about the same amount ---- A. It is not a construct, it is a balancing figure. It is  
5 the maximum that we could charge to the accounts of Albion that would continue to satisfy  
6 the OFWAT requirement that Albion was able to finance its functions.

7 Q But how is Albion able to comply with its regulatory accounting obligations without  
8 identifying the full extent of its costs of these statutory activities, if Envirologic is not a ----  
9 A. We did so in the full knowledge of OFWAT, that those costs, the costs over and above  
10 £30,000 were costs at risk, that the recovery of those costs relied wholly in the absence of  
11 any other business, and I am happy to go into that, relied wholly on our ability to pursue this  
12 action. We never knew it would take this long. We had no idea that it would involve us in  
13 appearing before this Tribunal, but these were actions that we had been fighting since 1995,  
14 and that is the only way. I have to say when, in late 2003, as the Tribunal is aware, Water  
15 Level sought to acquire Albion back from Pennan in so doing it had to satisfy OFWAT as to  
16 its business case, and at that time we made exactly the same point that risk would be carried  
17 by Water Level in the same way that risk was previously carried by Envirologic.

18 Q And the only way of meeting the risk they had assumed was to win this action? A.  
19 Fundamentally yes. What I have to say is that within the £730,000 administrative expenses  
20 of Envirologic, to which you have referred earlier, to look behind that you see a team which  
21 at that time was twenty-three strong; you see the BedZed Project; you see Hammersmith;  
22 you see Albion Yard and Bathhouse; you see a vast range of competitive initiatives that we  
23 were trying to take. So, it would certainly be entirely wrong to assume that the  
24 administrative expenses within Envirologic were solely, or even mainly, associated with  
25 Shotton. They were not.

26 Q So, what sort of figure would we be talking about if you added the Albion amount of  
27 administrative expenses that they could include in their accounts without looking financially  
28 unviable, and some part of the £730,000? A. I would need to look at the detailed Sage  
29 records to be able to pull that out. Those records do exist.

30 Q They do exist? A. They don't exist in our possession. Pelham should have them. I  
31 can't swear that they do. They may be able to help you. I have to say that this was  
32 information that was known and was reported to OFWAT at the time, and at any time there,  
33 or thereafter, they could have asked for the sort of detail that you now require. I am afraid I  
34 do not possess ----

1 MR. ANDERSON: Of course, we did at the beginning of this month, and the answer we got  
2 back was that ---- A. I have not had access to that information since May 2003. I  
3 regret that, but that is the fact. Would you like me to clarify about consultancy at Shotton,  
4 because I think that was another question you put to Mr. Jeffery?

5 THE PRESIDENT: What do you want to say about that, Dr. Bryan? A. There was indeed  
6 consultancy undertaken for Shotton. This is the earlier point. That was non-regulated. I  
7 think that was the point that was trying to be brought out. Where that consultancy was  
8 deemed to be non-regulated, it was deemed to be so because it did not impact directly on  
9 our primary role, which was the delivery of water to the mill. I can give you a couple of  
10 examples. My memory is not good enough to remember all of them. One was advice to  
11 Shotton Paper on possible alternative uses for paper sludges, which were de-inking sludges,  
12 which are a by-product of recycling newspaper. They were at that time being disposed of  
13 on farmland and that route was going to be closed to them. The other was that we did a  
14 significant amount of work for Shotton Paper's sister mill in Scotland relating to waste  
15 water treatment. Of course, that could in no way be deemed to be a regulated activity  
16 relating to the Shotton paper mill in Wales. Therefore, that, too, would be considered as  
17 consultancy, and was indeed charged on a man hour basis.

18 MR. ANDERSON: Finally, Dr. Bryan, you do appreciate how important it is for there to be a  
19 clear separation of regulated business from non-regulated business? A. I am acutely  
20 aware of that requirement.

21 Q You have recognised that in the business plans you submit to OFWAT. A. Absolutely  
22 right.

23 Q Thank you.

24  
25 (Further re-examined by Mr. Thompson)  
26

27 MR. THOMPSON: Just to clarify what the position has been Water Level took over as the  
28 parent company rather than Enviroligic ---- Where does the risk now fall? A. Some  
29 risks associated with the business still fall on Water Level, but the totality of the costs, the  
30 accounting costs, associated with the Shotton supply are reflected in the Albion accounts  
31 through a re-charge back to Water Level. As Mr. Jeffery said, Albion does not directly  
32 employ people – so, my time, Mr. Jeffery's time, the other director and our manager in  
33 Wales ---- that time is re-charged to Albion, together with the laboratory cost and other  
34 costs. What is left ---- What is not charged are certain contingent costs ---- I am sure Mr.

1 Thompson will not mind me saying, sir, that some of the fee arrangement that we have ----  
2 certain arrangements that we have with our accountants where costs are being treated on a  
3 contingent basis, depending on whether we win this ---- The directors, too, are absorbing  
4 certain risks – so that, for example, where we were having to put time into fighting the  
5 Thames appeal (the Albion Yard Bathhouse appeal) ---- Those were not costs that could in  
6 any way be legitimately charged against the revenues that we were getting from Shotton,  
7 particularly given the interim measures component of those revenues. Therefore, those costs  
8 are actually absorbed by the directors – in other words, we are giving 25 percent of our time  
9 without any remuneration so that we can still undertake some semblance of business beyond  
10 this case. I do not know whether that answers your question.

11 THE PRESIDENT: Dr. Bryan, just remind me: the Shotton paper mill is producing mainly  
12 newsprint, is it? A. Solely newsprint.

13 THE PRESIDENT: Thank you.

14 (The witness withdrew)

15  
16 PAUL ANDREW HOPE, Called

17 Examined by Mr. Anderson

18 Q Do you have a copy of your witness statement? A. I do.

19 Q Can you tell the Tribunal your full name and address and your current occupation? A.  
20 My name is Paul Andrew Hope. My address is 12 Shoal Green, Woodbridge Spa,  
21 Worcestershire. I am the Head of Tariffs at OFWAT.

22 Q Thank you. Is your witness statement signed? A. It is.

23 Q Is it your evidence to this Tribunal? A. It is.

24 Q Is it true? A. It is.

25  
26 Cross-examined by Mr. Thompson

27 Q Good afternoon, Mr. Hope. I have a short list of questions, all relating to your statement,  
28 and going through it, broadly speaking, in numerical order. The first area is in relation to  
29 paras. 12 and following where you raise the issue of the CCCWG, which one might call a  
30 sort of eminent persons' group, including Professor Littlechild, Professor Newbury, Mr.  
31 Hanks, and Dr. Corbett, which met, as I understand it, in 2000, and which formed an  
32 important background to MD163. Is that right? A. That's correct.

33 Q Then, when we look in para. 15 you have helpfully extracted from MD163 three paragraphs  
34 in italics there. In the middle paragraph, the last sentence says, "The ECPR requires reliable

1 information on avoidable costs which can be open to subjective interpretation”. Then it  
2 goes on, “In general, the accounting cost and LMC approaches are likely to produce lower  
3 access prices than ECPR, making entry more likely”. Then there is a reference to a possible  
4 increase in total costs, and then possible benefits in terms of innovation. Then, towards the  
5 bottom of the page there is a further quotation, and in the last bullet point there is a  
6 sentence, “Deterring entry that would have reduced these costs, so total costs in both the  
7 short run and the long run is likely to be a clear infringement of the 1998 Act”. Would you  
8 accept that MD163 expressed certain reservations about the use of ECPR as a pricing  
9 mechanism? A. I would. It did.

10 Q And would you accept that that reflected the views of the CCCWG? A. The views of  
11 the CCCWG were, as you would expect, given any panel of experts and divers ---- Some of  
12 the members of the group were more sympathetic to ECPR and some were less. What  
13 MD163 reports is the consensus view that there were reasons to have reservations about  
14 ECPR.

15 Q Did you ever reconvene CCCWG to reconsider the issue after the publication of MD163?  
16 A. No, we did not.

17 Q Did you consult other regulators – for example, OFTEL – as to their experiences of ECPR  
18 after issuing MD163? A. I can’t recall whether we did so after issuing MD163, but I  
19 do recall that we had informal discussions with other regulations. They are not documented  
20 and I do not have any record of them.

21 Q After MD163. A. I think it was before.

22 Q The second area – paras. 23 to 26 ---- Perhaps we should take it back to para. 21. There is a  
23 reference to a paper that you wrote, which you have kindly appended to this statement, and  
24 also to two reports from NERA, prepared on behalf of Northumberland Water. I suspect  
25 you know that ECPR is strongly favoured by incumbents generally – not only in the water  
26 industry ---- A. Yes.

27 Q Did you have any reservations about relying on two reports produced for an incumbent in  
28 this way? A. I think when I refer to the NERA reports later in the paper, I do say in  
29 para. 27 that notwithstanding the fact that NERA’s paper had been commissioned by an  
30 incumbent undertaker, we considered its arguments to be credible. So, yes, we did ---- We  
31 were aware that it was commissioned by an incumbent water undertaker, but nevertheless  
32 we considered its arguments to be fair.

33 Q But, you had reservations about using an incumbent’s paid-for report. But, you thought that  
34 the substance was credible. Is that fair? A. I wouldn’t say that we had reservations

1 about using an incumbent's report – only that we were aware that it had been prepared for  
2 an incumbent.

3 Q Yes. A. NERA is, after all, a credible – very credible – economic consultancy.

4 Q Yes. But, I suspect all the barristers here are credible, but their views coincide with those of  
5 those who are paying their bills, as it turns out. Paragraphs 25 and 26 give some extracts  
6 from the NERA report and set out certain conditions. I note in particular no. 3 in para. 25  
7 requiring that avoidable costs can be observed. Do you see that? A. Yes.

8 Q Paragraph 26 – reference to a need to overcome entry barriers. Do you see that? A.  
9 Yes.

10 Q So, did you accept those as part of the conditions for ECPR to be appropriate – that those  
11 concerns could be addressed? A. Probably not in the way that they are expressed here.  
12 I do not think it is fair to say that we would agree that it is necessary for avoidable costs to  
13 be observed transparently by all – but, rather, that they at least be transparent for an  
14 authority that may be asked to make a determination of an access price.

15 Q That was a concern of the CCCWG---- A. That there should be transparency, yes.

16 Q And it was a concern expressed here by NERA. Yes? A. Yes.

17 Q What about entry barriers? Was that a concern, or not? A. What exactly do you  
18 mean by 'entry barriers'?

19 Q There were conditions under which access prices lower than ECPR might generate more  
20 efficient outcomes. The second one: there is a need to overcome entry barriers. As I  
21 understand it, they are saying that where that arose there might be a problem with ECPR, to  
22 put it crudely. A. We took the view that there were no entry barriers above and beyond  
23 those that would be taken into account by what became the water supply licensing regime,  
24 or became the water supply licensing regime, there were no barriers or problem beyond  
25 those.

26 Q You do not mention entry barriers, I think further on, but did you accept that there might be  
27 a problem about ECPR if there was a need to overcome entry barriers, that is the point of  
28 principle that is being stated there, did you accept that? A. Yes, we would accept that.

29 Q Thank you. Can we now go on to paras.30 and 32 of your statement? In the middle of 30  
30 you say: "Under ECPR we could be certain that entry would at least reduce total costs in the  
31 short run". Do you see that? A. Yes.

32 Q Then at the bottom in 32 you say: "There was a greater probability ECPR would encourage  
33 entry that would reduce total costs the most over the long run". I would just like to explore  
34 how you reached those conclusions given that the CCWG had suggested that ECPR might

1 deter entry, so how could entry reduce total costs either at all or in the short or long run if no  
2 such entry took place? A. I think what the statement is saying is that to the extent that

3 there is entry under ECPR it would be entry that would, with certainty, reduce total costs.

4 Q If there were no entry and if it deterred entry then obviously those benefits would not be  
5 achieved, would they? A. If there were no entry then, in our view, that would be

6 precisely because the potential entrant (or entrants) would not be able to reduce total costs,  
7 would not be able through their act of entering to reduce total costs.

8 Q How could it encourage entry to reduce total costs if it prevented it? A. Perhaps the word  
9 “encourage” was ill-advised. It would allow entry that would reduce total costs the most  
10 over the long run.

11 Q Perhaps you mean it would not allow entry that would not reduce total costs. Is that ----  
12 A. Better still.

13 Q At para.33 you say that “ECPR performed particularly well against objective B”. As I  
14 understand Objective B that was the risk that customers who could not benefit from  
15 competition did not have to pay more as a result of customers who could benefit from  
16 competition. A. That is right.

17 Q Did you give any thought to the fact that that did not give any weight to the short term  
18 effects on customers who were potentially able to benefit from competition which was  
19 prevented because of use of ECPR? A. I am sorry, I do not understand the question.

20 Q Well, Objective B, the position of customers, you are looking here only at customers who  
21 are unaffected by competition? A. Yes.

22 Q Did you give any thought to the position of customers who could have benefited from  
23 competition but did not because nothing happened? A. Indeed, I think that is effectively  
24 tackled by Objective A to the extent that entry improves efficiency, it must do so because it  
25 is beneficial to the eligible customers, so the next question becomes is that entry harmful to  
26 the ineligible customers, and that is the separation between Objectives A and B.

27 Q What about the long term position of customers in both classes who might have benefited  
28 from competition in relation to the market generally, did you give any weight to that? A.  
29 Given that A is tackling the issue of overall efficiency, I am not quite sure where your  
30 question is going. Yes, we gave weight to that.

31 Q I think the position is if there was no competitive entry because of the deterrent effect of  
32 ECPR then nobody would benefit? A. Well if there was no competitive entry because of  
33 the deterrent effects of ECPR then our view was that any entry that would otherwise occur  
34 would actually have been harmful to customers as a whole.

1 Q Yes, I see. Then finally, objective C you deal with para.34 and I think that is essentially a  
2 non-discrimination condition between the incumbents, downstream arm, and the position of  
3 entrants. As I understand it, what you are saying is that there was no subjective reason  
4 for the incumbent to discriminate under ECPR, is that right? A. That is correct, yes.

5 Q I think that is what you were saying there. But objectively, surely there would be a serious  
6 risk of discrimination because of the need for the entrant to bear fixed as well as avoidable  
7 costs while only having the ECPR margin with which to compete. Would that not be a  
8 serious risk? A. I would not regard that as being discrimination. If the objective is to  
9 ensure that entry occurs only when it is efficient, only when it reduces the total costs of  
10 supplying all customers then that form of discrimination – if you wish to describe it as  
11 discrimination – is something that we would regard as acceptable.

12 Q I think all I am saying is that para.34 appears only to look at the subjective incentives of the  
13 incumbent, and does not look at the objective position of the incumbent as against the  
14 entrant. Is that correct? A. I am still not sure I understand your distinction between  
15 subjective and objective in this case.

16 Q As I understand it, para.34 says you cannot observe the position, but there is a level playing  
17 field, effectively in terms of the incentives of the undertaker. Is that not the point you are  
18 making? A. That is the point, yes.

19 Q But there is no level playing field in terms of the costs position of the undertaker, and of the  
20 entrant. That is the point I am making? A. No, there is not.

21 Q Thank you . From para.36 onwards you address the issue of ECPR and a possible variant of  
22 ECPR using LRMC as a proxy for avoidable costs, is that right? A. Yes.

23 Q And your concern was about avoidable costs, is that right? A. And so you wanted a  
24 discount based on a form of total costs, or some variant on LRMC, some sort of proxy  
25 instead of avoidable costs? A. Yes.

26 Q Then if we turn over the page to para. 37, the second paragraph on the second point, that is  
27 an issue about resource costs. Is that right? A. It is, yes.

28 Q So you had a concern about avoidable costs and it was addressed in relation to resource  
29 costs, is that right? A. Yes.

30 Q There is nothing here about downstream costs, and costs of retail? A. About retail costs,  
31 we do also have knowledge and understanding of retail costs. The point is made in terms of  
32 resource costs but it has more general applicability.

33 Q That is not the point you make in your statement, that relates purely to resource costs? A.  
34 I refer only to resource costs in my statement, yes.



1 Q We have a document which is appended to Mr. Jeffery's second statement, which I suspect  
2 is a document you have seen. I do not know if you can be provided with that bundle. It is  
3 the last tab in the bundle, and if you turn to p.20 you should find a document called  
4 "Development of a Revised Access Code Draft Guidance on Access Pricing". Do you have  
5 that? A. Yes.

6 Q The bundle of Dr. Bryan and Mr. Jeffery's statements, tab.10, p.20. It has a date of 18<sup>th</sup>  
7 April 2006 on it, but I think that was the date it was printed out. Is it a document that you  
8 are familiar with? A. Yes.

9 Q Our understanding is that it was produced at about the same time as the Decision at the  
10 beginning of 2004? A. Yes.

11 Q If you turn through it to p.7 of the documents, p.26, there is a heading "Methodology  
12 Wholesale Prices". It says

13 "For wholesale prices zonal measures of avoidable costs are likely to be irrelevant  
14 because retail costs tend not to vary within an undertaker's region. So average  
15 cost measures for each undertaker may be appropriate.

16 We think that calculating LRMC for retail would be particularly difficult. And  
17 companies' accounts do not provide enough detail on the separate elements for  
18 retail costs to form a basis for a measure of avoidable costs. So we propose to  
19 seek further information from undertakers on the costs of individual retail  
20 activities, although we would need to check this for consistency with undertakers'  
21 accounts."

22 Is it fair to say that, as at the date of **this**, you were not in a good position to monitor retail  
23 costs and avoidable costs for retail? A. Yes.

24 Q So why is there nothing about that in your statement, in terms of your concerns over  
25 avoidable costs? A. Because the solution that is offered in this guidance was always  
26 available to us to seek further information from companies. We have quite extensive  
27 powers to seek information from the water company.

28 Q But the problem I have is as at the date of this Decision you had, as it were, plumped for  
29 ECPR in circumstances where you recognised yourself that you were not in a position to  
30 monitor downstream costs for retail. Is that not the position? A. No, that is not the  
31 position. Sorry, could you repeat the exact phrasing that you have just used?

32 Q Well we have just looked at a document which indicates that at the time of the Decision you  
33 were not in a position to monitor retail costs for ECPR and you recognised that yourself?

1 A. We did not have the information at that time, but we would have had access to that  
2 information at our request.

3 Q Yes, but you took a decision in this case at about the same time without having obtained any  
4 such information. Is that not correct? A. I cannot comment on the specifics of the  
5 information on retail cost that we obtain in relation to the Shotton case because I was not  
6 closely involved in that.

7 Q I misunderstood your witness statement. I thought you said you drafted the section on  
8 ECPR in the Shotton Decision? A. No.

9 Q The para.4? A. No, I said I was involved in the drafting, I did not say that I drafted it.

10 Q I see. So there was nothing about avoidable costs in relation to downstream services in your  
11 statement, and you will recall that we identified the issue of barriers to entry and there is  
12 nothing in your statement to suggest that the issue of barriers to entry was addressed in  
13 relation to the difficulties of ECPR in the water industry. There is nothing about that here in  
14 your statement is there? A. No, there is nothing explicit about that in the statements.

15 Q Those are the questions I had.

16 THE PRESIDENT: Mr. Hope, I wonder if I could – unless anyone else has any cross-  
17 examination. Sorry, Mr. O'Reilly, yes, please?

18 Cross-examined by Mr. O'REILLY:

19 Q Mr. Hope, I would like to ask you about the application of the costs' principle which is  
20 referred to in the Decision as one of the cross checks, and if I can ask you to look at para.6  
21 to start with. In your witness statement it says "The Tribunal has also raised a number of  
22 other points on ECPR, for example on the linkage between ECPR and the costs' principle  
23 introduced by the Water Act 2003 ..." it says there I understand it is something that will be  
24 dealt with specifically in OFWAT's further submissions, but I would like to ask you a  
25 question about that in a minute.

26 MR. ANDERSON: I should point out that Mr. Hope was not responsible for the drafting of the  
27 Decision so just in much the same way as I fell down on Albion's accounts, he is not really  
28 the person to put things to.

29 THE PRESIDENT: He is being asked about para.6 of his witness statement at the moment, but  
30 thank you for that clarification, Mr. Anderson.

31 MR. O'REILLY: Just on that point, it is an easy mistake to make because para.4 does say: "I was  
32 involved in the Shotton case and in particular in the application of the efficient component  
33 pricing rules of the case. I was involved in the drafting of those sections related to ECPR in  
34 OFWAT's original Decision."

1 THE PRESIDENT: I am sorry, Mr. Anderson, you have just told us that Mr. Hope was not  
2 involved in the drafting? It is not what this witness statement says?

3 MR. ANDERSON: I apologise for that, I understood that he was not, but then again ----

4 THE PRESIDENT: He says he was? A. I was involved in the drafting to the extent that I was  
5 consulted on it. I did not draft it, and nor am I an expert on the details of the application of  
6 ECPR to the Shotton case.

7 PROFESSOR PICKERING: But that was your particular contribution, you say, in para.4? A.  
8 My particular contribution was in terms of, it does indeed say I was involved in the Shotton  
9 case, and in particular the application of it to the case, but not to the detail. I was involved  
10 at a high level to the principles involved with applying it to the Shotton case. I am sorry if  
11 that is not clear enough.

12 PROFESSOR PICKERING: You were involved in the drafting of those sections relating to  
13 ECPR. A. But, again, from the point of view of the principles involved – at a high  
14 level – rather than with regard to the specifics.

15 THE PRESIDENT: But presumably you saw quite a late draft of what was coming out and you  
16 were happy with it. A. Yes.

17 MR. O'REILLY: In particular with the fact that the way that the access price was computed was  
18 on the basis that the price was 25.8p (I believe it was) which was the retail price minus the  
19 3.3p which was the input water price, and there was no other deduction for retail services?

20 A. Yes My understanding from colleagues was that the reason there was no other  
21 deduction for other services was that the service that Welsh water would be expected to  
22 provide to Albion Water in terms of retail was essentially the same as the service that Welsh  
23 Water would have been expected to provide to Shotton Paper. So, on that basis there did  
24 not appear to be any avoidable costs, any arrow costs.

25 Q Was any analysis undertaken of whether or not there would have been any avoidable costs,  
26 or was it simply taken as a given? A. I understand that analysis was undertaken. I  
27 didn't undertake it myself.

28 Q Do you know who would have undertaken it? A. Colleagues at OFWAT.

29 Q Turning to para. 39, starting at the bottom of p.12, this is under the heading 'ECPR and the  
30 Shotton Decision', at the top of p.13 you go on and talk about the consultancy through  
31 CCCWG. Then, at the centre of that top paragraph on the page, you say, "Concerns we did  
32 have about ECPR, such as the practical question of whether using proxy for avoided cost  
33 was more sensible had been removed by the time the decision was made". Then you carry  
34 on, "Importantly, by then, the credibility of ECPR had also been reinforced by the

1 imposition of the costs principle through the Water Act 2003”. In para. 40, in the centre of  
2 the paragraph, you say, “At the time of the decision we thought that ECPR was a perfectly  
3 justifiable alternative methodology for these purposes. In light of the extensive work we  
4 had carried out on it in the previous four and a half years, and the fact that the costs  
5 principle had been enshrined in the Water Act 2003”. So, there are two references to ECPR  
6 being enshrined in the Water Act. The final sentence of para. 40 states, “As set out in para.  
7 318 of the Decision, for this reason when improving tariffs we examine the proposed tariffs  
8 from more than one perspective”. That is a reference, is it not, to dealing with ECPR and  
9 Section 66(e), the costs principle? A. Yes.

10 Q How did you come to the view that Section 66(e), headed ‘The Costs Principle’, was  
11 ECPR? A. Well, OFWAT was closely involved in the development of the costs  
12 principle with DEFRA. So, we understood that the costs principle was, in effect, an  
13 embodiment in the Water Industry Act of ECPR – to all intents and purposes.

14 Q The text of Section 66(e) is what the principle is. Correct? A.

15 Q Did you analyse that text? A. We did.

16 Q And you came up with the view that it meant ECPR? A. Yes.

17 THE PRESIDENT: Are we drifting on to issues of law, Mr. O’Reilly?

18 MR. O’REILLY: I am simply trying to understand, sir, how it was that OFWAT came to the  
19 view that Section 66(e) was an embodiment of ECPR. I recognise that it is a legal question  
20 – whether or not it is ---- A. In short, because Section 66(e) describes the calculation  
21 of access prices by beginning with retail revenue and subtracting costs that could be  
22 avoided, reduced or recovered in some other way. In effect, that retail minus formulation  
23 seems to us to be consistent with the efficient ----

24 THE PRESIDENT: So, you read Section 66(e) as starting with a retail minus formulation.

25 A. Section 66(e) is drafted in quite a complicated way, but there is reference in there to a  
26 starting point of revenues that an undertaker would recover from which are subtracted  
27 various costs elements.

28 PROFESSOR PICKERING: Are you actually really leading us to conclude, Mr. Hope – or  
29 should we conclude – that actually OFWAT advised DEFRA that this is how ---- not  
30 necessarily how the Section should be drafted, but this was the outcome that you were  
31 advising should be sought? A. I think it would be fair to say that DEFRA had already  
32 stated in its consultation document the form of access pricing ---- the objectives that it had  
33 in mind for access pricing ----

34 Q No doubt with your advice. A. No doubt, yes.

1 Q So, there was an interaction ---- I mean, looking at the process, there was an interaction  
2 between OFWAT and DEFRA whereby OFWAT was saying to DEFRA, “Well, this is  
3 what we think ought to be the way in which this is handled in this industry”. A.  
4 Indeed, we did offer a view, yes.

5 Q And DEFTRA bought the view. A. I think it would be unfair to say that DEFRA  
6 ‘bought’ the view. DEFRA had views of its own, and it may well be that DEFRA’s prior  
7 view was already one that was consistent with ECPR.

8 Q But that was what OFWAT was advising DEFRA. Thank you.

9 MR. O’REILLY: It seems to me, just looking at Section 66(e) that there is no reference at all to  
10 retail. The word ‘retail’ does not appear in that section. So, that was an inference that you  
11 drew from the text, was it? A. It was.

12 Q Can I suggest that what actually DEFRA had in mind is expressed in an extract from the  
13 consultation paper that you give at para. 28 of your witness statement? A. Sorry.  
14 Before you go too much further, I should say that I am not really in a position to second-  
15 guess what DEFRA had in mind.

16 Q No. I understand that. (After a pause): But, you were involved in formulating the view of  
17 OFWAT as to what the principle meant. A. Yes.

18 Q Did you take legal advice? A. Did we take legal advice on ---?

19 Q On the meaning of Section 66(e)? A. Yes. We consulted with our legal colleagues,  
20 yes.

21 Q Internally? A. Yes.

22 Q Were you aware that on 26 May, 2004 – which is the date of the decision – that Aquavitae  
23 wrote to OFWAT, to Beryl Browne, asking for a lawyers’ symposium to discuss the  
24 meaning of Section 66(e)? A. No, I’m not aware of that.

25 Q So, you would not have been aware of her response either, saying, “No” effectively? A.  
26 I cannot recall it, no.

27 Q The extract from the consultation paper which is set out at para. 28 of the witness statement  
28 says that, “The government believes that whatever methodology, or methodologies, are  
29 chosen, the access charges should be consistent with three general principles. These are: (1)  
30 undertakers’ prices for distribution and wholesale supply should not in themselves deter  
31 potential licensees from seeking to supply customers. This implies that they should reflect  
32 the actual costs of providing the service. They should not be unduly discriminatory and they  
33 should be transparent”. So, if we knock out some of the irrelevant words for constructing a  
34 shortened sentence, we have ‘undertakers’ prices for [let us say] wholesale should reflect

1 the actual costs of providing the service'. That is why it is called a costs principle, is it not,  
2 Mr. Hope? A. Yes. But, if you go on to read the following bullet points, you will see  
3 that the government also expected access prices to compensate for stranded asset costs.

4 Q Yes. It says, "If licensees abstract and treat their own water, there could be a risk of  
5 stranded assets", and that was not what happened here, was it? A. Sorry. I don't  
6 understand your point.

7 Q Well, the government had a difficulty with stranded assets, and it made specific reference to  
8 those. That was in the event that they should become a problem. The headline principle  
9 here is that the undertakers' prices should reflect the actual costs of providing the service.  
10 That is no a retail minus principle, is it? A. I don't have Section 66(e) in front of me,  
11 but there is a reference in 66(e) to the revenues that an undertaker would recover.

12 THE PRESIDENT: You are not expected, Mr. Hope, to take a punt at the legal issues of the  
13 construction of Section 66(e).

14 MR. O'REILLY: (To the witness): I am not asking you for a legal opinion. I am simply  
15 trying to work out how OFWAT arrived at the view that Section 66(e) and ECPR were one  
16 and the say thing. A. It's very difficult for me to do that without reference to Section  
17 66(e) and, indeed, to take the President's line, to have a legal punt at interpreting it.

18 MR. ANDERSON: I think the witness has made quite clear that that was OFWAT's view.  
19 Whether that was the right view to hold, or not, is a matter for legal submissions.

20 THE PRESIDENT: What I have taken so far from this is that so far we have had no particular  
21 factor beyond the wording of Section 66(e) that, as it were, links 6 and 66(e) with ECPR in  
22 terms of a retail minus approach. A. Other than the objectives, I think, that were  
23 expressed. The way that the government expressed its objectives in its consultation paper.  
24 It did seem to us to be consistent with what ECPR is expected ----

25 Q You would say that the consultation paper is a good starting point, or a sound starting point  
26 for working out how it all happened. A. Yes.

27 MR. ANDERSON: I am just asked to point out that there is, of course, in addition to the  
28 wording of Section 66(e) the fact that OFWAT's evidence is that they believed that to be  
29 the case.

30 THE PRESIDENT: No doubt they did believe it, but just trying to work out why, or how, or by  
31 what route ----

32 MR. O'REILLY: (To the witness): Were you involved in producing the guidance which  
33 followed on from the publication of the Water Act? A. I was involved in it, but, to be

1 clear, given my comment earlier about being involved in things, I did not draft it, but I did  
2 comment upon it.

3 Q Did you have a look at some of the examples that were produced? A. ... (inaudible) ...

4 Q And do you recall the example which appears – and perhaps I can hand up a copy ---- I  
5 believe that the Tribunal should have copies of the Guidance as well. (Handed) What you  
6 have there, Mr. Hope, is an extract from the Guidance. If I could ask you to turn to p.48, we  
7 see there an equation – 6.5.1: the access prices = any expenses reasonably incurred plus  
8 retail charge minus the ARROW costs (that is, the costs that are avoided, reducible, or  
9 recoverable in any other way). Did you have a hand in drafting the way that this equation  
10 is set out? A. No, but I was aware of it.

11 Q Can I ask you to turn to some of the examples? Can I ask you to turn to Appendix 2 at  
12 p.63. Here we go through a detailed calculation. So, for example, the first set of figures are  
13 ---- The example starts at the middle of p.63. That is wholesale prices. We see the retail  
14 charge there, and the example that is given is at the bottom of the page – a fixed charge of  
15 £5,000 for this particular customer; a maximum daily demand charge of £70 per cubic  
16 metre, and a volumetric charge. In this particular worked-up example, the total is  
17 £346,000. So, that is the retail charge that would be applied to that particular customer.  
18 There is then a sample calculation of ARROW costs undertaken. You will find those at  
19 Table A2.1 at p.65. That arrives at a total of £606 being the avoidable costs. In addition, the  
20 equation that we had a look at at 6.5.1 requires the addition of the expenses - that is at p.67,  
21 Table A2.2 – giving expenses to the incumbent of £209. The net position is set out at p.68.  
22 We see at Table 6.7.1 a total discount of £397. Do you see that? A. Yes.

23 Q So, for a retail charge of £346,781 the retailer has to buy at a discount of only £397. Did  
24 you check through this calculation at all? Were you involved in ---- A. I will have  
25 seen this, yes.

26 Q Did you think that that was in line with what DEFRA wanted in terms of applying  
27 competition to the industry that there should only be a 0.1 percent margin even for such a  
28 large supply of water? A. This was an example of how to undertake an access price  
29 calculation. It is not a prediction of a likely level of access prices.

30 Q Right. Presumably, when compiling the example, realistic figures would have been input,  
31 would they not? A. Well, I seem to recall that there were other examples which would  
32 have been consistent with entry appearing more attractive. You are quoting selectively an  
33 example in which entry might appear to be unattractive.

1 Q Are you aware of the access prices? The indicative access prices published by water  
2 companies? A. Yes. Sorry. Is this still within the remit of my witness statement?  
3 Q I am simply asking. A. Yes, I am aware.  
4 Q You said that you were involved in the preparation of this guidance. I am simply asking  
5 about that. A. Yes.  
6 Q Are you aware that some companies publish indicative access prices that give a zero  
7 margin? A. I am aware of that, yes.  
8 Q Have you taken steps to check whether that is appropriate or not? A. We have.  
9 Q Okay. What is your provisional view? You are a senior economist working for OFWAT?  
10 A. No. I am the head of the tariffs team. I am no longer a senior economist. Well, our  
11 view was that we asked the companies concerned to explain the basis on which you could  
12 arrive at an access price which was higher than the retail charge. The company explained  
13 the assumptions that it had made in reaching that price, and on those particular assumptions  
14 we did not consider the company's indicative access price to be unreasonable.  
15 Q Zero margin in that case, on those assumptions - we are not going to go into that case - was  
16 considered by OFWAT to be a reasonable margin in these circumstances. A. Yes.  
17 MR. ANDERSON: Whilst talking about access guidance under the new regime we took great  
18 exception to Aquavitae putting in all this access guidance stuff after the last hearing. There  
19 is no conceivable way it can arise out of anything in the interim Judgment.  
20 THE PRESIDENT: Mr. Anderson, the interim Judgment very clearly links the costs principle to  
21 the ECPR as used in the decision, and by way of background it is of some interest, I think,  
22 to see how ECPR works, or is now seen to be working now that we have got a bit more  
23 information about it.  
24 MR. ANDERSON: My learned friend should also have been putting to the witness in the  
25 context of the paper he has just been putting to him this second paragraph on p.63 which  
26 would have made perfectly clear the point about them being illustrative figures.  
27 THE PRESIDENT: If you want to come back in re-examination, or you want to come back later  
28 in writing, you are very free to do so.  
29 MR. O'REILLY: (To the witness): Mr. Hope, I just have one further point. I am instructed that  
30 there were indeed some better prices in the draft guidance, but those were then withdrawn  
31 before final publication. Are you aware of that having happened? A. I am aware that we  
32 may have changed the list of examples that we used in the Guidance that we published, yes.  
33 But again, you know, I draw your attention to the fact that these examples are there purely



1 for illustrative purposes in terms of the methodology for making a calculation. They are not  
2 there for predictions or an indication of what we think is likely to occur in practice.

3 PROFESSOR PICKERING: Do you not think that there is a very considerable responsibility on  
4 any Regulator to be extremely careful not to appear to be setting the tone for its industry in  
5 terms of almost acting as – forgive me, I am using this in quotation marks, Mr. Anderson, -  
6 but almost acting as the “price leader”? We know at times that Governments acts as price  
7 leaders whether wittingly or not, but I would have thought that a Regulator would recognise  
8 the responsibility to be very careful not to send any implied messages that may affect the  
9 way in which its constituent companies addressed particular price indecisions? A. Yes, I  
10 would accept that point. As I said earlier, I do not have the full text in front of me, I have  
11 only this selective test from the Guidance on Access Codes, but my recollection is that we  
12 had examples, even in the final published version that would have appeared more  
13 favourable to a potential entrant.

14 MR. O'REILLY: If that is the case then I am sure submissions can be made on that. Were you  
15 aware that some companies were charging for switching to retail? A. To wholesale  
16 price?

17 Q Sorry, were you aware that some water companies were charging a fee?

18 THE PRESIDENT: I do not think that that arises in this case does it, Mr. O'Reilly?

19 MR. O'REILLY: No, not in the case of Shotton it does not.

20 THE PRESIDENT: Well I am not sure it is a wholly relevant question if it does not arise in this  
21 case.

22 MR. O'REILLY: In that case I withdraw it, Sir, and no further questions.

23 THE PRESIDENT: Right, thank you. I think we will just rise for five minutes. Mr. Hope, by all  
24 means rise with us, as it were, but I have one or two questions myself when we come back,  
25 so if you would be kind enough not to discuss your evidence with anyone else until we  
26 come back. Thank you.

27 (Short break)

28 THE PRESIDENT: Mr. Hope, if I may, the Tribunal is trying to sort out the history of all this and  
29 what happened when, and it is not entirely straight forward, so we are very glad of your  
30 help, and if I get something wrong you will put me right, please. On p.8 of your witness  
31 statement at the top there, you are referring to the second of the NERA papers which was in  
32 March 2001, which followed an earlier paper in March 2000, and you set out in that  
33 paragraph various requirements for ECPR to be effective, including that the final prices

1 must be regulated, services must be substitutable and voidable costs can be observed, that is  
2 clear what that paper says.

3 Now, I have not gone back to look at it, and we can look at it, if necessary overnight, but as  
4 I recall it that paper at that stage was talking about the water industry as a whole. Is that  
5 right? A. Yes.

6 Q By which I mean that that paper was not addressing whether there was any relevant  
7 difference between the generality of household or smaller customers and the larger  
8 industrial customers. A. No.

9 Q If I have the chronology right, for the charging year 2001/2002 Industrial customers above a  
10 certain size were taken out of the tariff basket and my general question, and I am going to  
11 put it very generally so you may give as general an answer as you wish, is how far in your  
12 view, as regards large industrial customers is the first of those conditions met, namely that  
13 final prices must be regulated. What, in the relevant period of regulation is there, as regard  
14 prices to large industrial customers, particularly those on special agreements? A. The  
15 policy is to larger customers, customers that have been covered first, those that are  
16 published in companies' charges' schemes, in most cases they make up the bulk of large  
17 user charges, are submitted to OFWAT for approval. So we approve charges that are in  
18 companies' charges' schemes, and that apply generally to customers of a given class. So we  
19 have powers of approval. We examine those charges each year to ensure that that they are  
20 consistent with companies' condition of appointment E, which requires ----

21 Q This is the non-discrimination condition? A. Yes, neither unduly preferential or unduly  
22 discriminatory, and we do so by comparing those charges with other charges, in particular  
23 with regulated charges that are contained within the tariff basket. So in that sense we would  
24 not expect to see any noticeable divergence between rates of increase in prices for large  
25 users and prices for customers who are within the tariff basket, without good reason.

26 Q Is it fair to infer that prices to industrial customers, as I think the earlier OFWAT  
27 submissions told us are less regulated than final prices to the generality of retail customers?  
28 A. Yes, they are in the sense that they are not subject to the price limit, explicitly.

29 Q They are not subject to the price limit. And in terms of special agreements where there is no  
30 tariff it comes down to Condition E, is that right? A. Yes.

31 Q Yes. In relation to the next requirement, which is not there but a little bit later on in the  
32 consultation paper, which I think you think is as good a starting point as any for the  
33 discussion that is going on in this case, there is a reference – and it comes up several times  
34 in your evidence – to stranded assets and the cost of stranded assets? A. Yes.

1 Q In terms of the Shotton case, how does the stranded asset argument, as it were, play because  
2 we have an asset that is being used and is not going to be stranded, indeed the contrary?

3 A. Well my understanding is that the same assets – essentially the same assets would be  
4 used regardless of who is the designated supplier to Shotton Paper, so yes, there would be  
5 no stranded asset, which is why the avoidable cost in the ECPR calculation that OFWAT  
6 undertook was the bulk supply price from United Utilities.

7 Q I suppose what I am struggling for is the question how does a pricing approach that is  
8 intended to deal with stranded asset costs help us in a case where, by definition, there is not  
9 going to be a stranded asset? A. Well it deals equally well. If there are no stranded assets  
10 then that will be reflected in the access price.

11 Q In what way? A. Well to the extent that there are going to be stranded assets then it is  
12 more likely that the access price will be higher. The lower the likelihood of stranded assets  
13 then the lower the likely the access price, the greater the avoidable costs.

14 Q Sorry, say that again – i.e. the more – repeat that because I am rather slow and I could not  
15 quite understand it all? A. If there are not any stranded assets then the avoidable costs are  
16 likely to be higher. The lower the risk of stranding the greater a company's avoidable costs  
17 are likely to be.

18 Q “The lower the risk of stranding the greater the avoidable costs are likely to be”? A. Yes,  
19 all else being equal.

20 Q But in this case we have a nil risk of stranding? A. Yes.

21 Q Quite a low figure? A. The avoidable costs were low because the resource costs were  
22 low, they were low in value. The bulk supply price was low.

23 PROFESSOR PICKERING: Just following that, if the probability of stranding was very high, let  
24 us assume that the probability was one that there would be stranding by bypass, how then  
25 do you get any contribution towards the cost of those stranded assets? A. If the assets  
26 were going to be stranded then avoidable costs would be correspondingly lower, and the  
27 access price would be close to the retail price, if not equal to it.

28 Q I do not see how this would apply. Let us suppose that something equivalent – you are not  
29 arguing that this would have been replicable in the Shotton case, but just suppose that  
30 Albion took its water supplied from United Utilities, was able somehow or other to bypass  
31 the Ashgrove system and deliver direct to Shotton Paper, it has no contractual arrangement  
32 with the company whose assets were stranded, so how can you say that ECPR can deal with  
33 stranding, and furthermore you seem to be saying that one is taking a forward view about  
34 the probability of stranding and that you build that in, but I mean ECPR is actually about

1 observing avoided costs. So is there not a fundamental problem that ECPR cannot actually  
2 pick up a provision for stranded assets? A. It does in the way that avoidable costs are  
3 calculated, if there are going to be stranded assets then avoidable costs will be smaller. If  
4 there are not going to be stranded assets then avoidable costs will be greater and access  
5 prices will be lower.

6 Q So, in this case you are saying that there would not have been stranded assets. So, the  
7 ARROW costs should have been up. A. My understanding in this case is that the  
8 avoidable costs would be the costs of the bulk supply for the United Utilities, but you will  
9 have to correct me if I am wrong. Since Dwr Cymru would no longer be taking bulk  
10 supply from United Utilities, then it would not be incurring specifically those costs. It  
11 would be able to avoid them. Those are the avoidable costs, but the assets are not stranded  
12 because those assets are being deployed to supply Albion Water.

13 Q I think it is the other way round, is it not? The raw water is provided by United Utilities.  
14 The common carriage system is provided by Dwr Cymru. A. Yes.

15 Q Perhaps you could tell us this: how then did you handle the comparison within your tariff  
16 setting and your approval of the bulk supply price? How did you compare the possibility of  
17 stranded assets against the likelihood that the assets would not be stranded? Did you have  
18 a counter-factual position that you considered in this case? A. I'm not sure what you  
19 mean by that.

20 Q You are saying that if there would be stranded assets, then the avoidable cost would be  
21 lower. Right? A. Yes.

22 Q And if there are no stranded assets, then the avoidable cost would be higher – the ARROW  
23 cost would be higher, so the price would be lower under the ECPR. A. Yes.

24 Q I am saying: did you actually go through two separate calculations in assessing the ECPR-  
25 based price in this Shotton Paper case? A. I didn't undertake the calculations. So, I  
26 couldn't ----

27 Q Well, did your colleagues? I mean, you have been involved at a high level, you tell us, in  
28 this, and I am sure that the establishment of a counter-factual would have been part of the  
29 high level role that you would have played. A. And the counter-factual would be what  
30 would have happened if ----

31 Q If there had been stranded assets. A. I don't recall that we considered that case, no.

32 Q You do not. A. No.

33 Q Let me come back to the basic question which the President put: how realistic is it to talk  
34 about including within the price some sort of provision on the basis of an expectation as to

1 the probability that some, or all, of the assets will be stranded? A. Well, companies  
2 have to provide all the time ---- Each year they have to provide assessments of what water  
3 resources are required to meet their supply obligations. So, they are in the business of  
4 forecasting what resources are required to meet demand. They have to allow for different  
5 scenarios. So, it is not unusual for water companies to have to make a forecast as to what  
6 resources they will need to meet demand. That is precisely what you do in the calculation  
7 of an ECPR access price. You compare two scenarios. You compare your base case  
8 scenario - the demands you are expecting to have to meet – with a hypothetical scenario,  
9 which is the base case minus whatever demands are relevant to the customer that an entrant  
10 is going to supply. So, you compare two supply/demand investment programmes, and you  
11 calculate the difference. The difference is the avoidable costs. So, if some of the assets are  
12 not going to be able to be used in some other way, or not going to be avoided, and so on,  
13 then since they are not avoidable, the access price will remunerate the undertaker for those  
14 costs.

15 Q Assuming that the undertaker remains the undertaker and that there is not a bypass.

16 THE PRESIDENT: I think what Professor Pickering is getting at is this: if, as was at one time  
17 suggested in the annex to the decision, there was simply another supply to Shotton from  
18 somewhere else, or a new pipeline (as we have been discussing in the course of the day), the  
19 existing pipeline would be stranded – but on the basis that it is a supply direct from United  
20 Utilities/Albion to Shotton there is no-one from whom Dwr Cymru can recover the cost of  
21 that asset. It has just been stranded. It has been bypassed. So, we have got a situation  
22 theoretically in which if the asset is stranded there is no mechanism for recovering the cost  
23 of that stranded asset, but if the asset is not stranded, nonetheless the entrant has to pay,  
24 under a pricing mechanism designed to protect the incumbent from stranded assets, even  
25 though the asset is not stranded. Do you see what I mean? A. Yes. ECPR does not  
26 provide for situations involving bypass.

27 Q No.

28 PROFESSOR PICKERING: If you could look at para. 28 and the second bullet point there ----  
29 I recognise that this is the DEFRA consultation paper. Does what is said there actually  
30 then still hold? If undertakers were not compensated for these stranded asset costs, how do  
31 you do it? A. Well, the costs principle provides for the kind of circumstances that arise  
32 under the water supply licensing regime. So, they work for those kind of circumstances. I  
33 think the scenario you are talking about involving bypass is outwith the water supply  
34 licensing regime, if I have understood it correctly.

1 THE PRESIDENT: It is the scenario the Director developed in an annex to the decision. It  
2 might be said that that scenario is, in a sense, self-defeating because it would give rise to a  
3 stranded asset that the current pricing policy is designed to avoid. So, in other words, what  
4 we are trying to get at is: if there is a bypass, does this rule help, on the one hand? If the  
5 asset is fully used, what is the relevance of the reference to stranded assets? I suppose  
6 thirdly – and this is probably what you might say: is there some intermediate position where  
7 there is partial stranding which needs to be taken into account? Do you follow what we are  
8 trying to ---- A. I think I do. My understanding is that the key point is the one that I  
9 made a few moments ago – that ECPR does not provide for cases of bypass. But, in the  
10 context of the costs principle nor is it intended to. It is intended to apply to the  
11 circumstances that arise under the water supply licensing regime.

12 Q I think, just to complete this part of the case, if we go back to p.10 of your witness  
13 statement, under the heading ‘(b) Protecting customers’, you are talking about protecting  
14 those who are unable to benefit directly. You refer to the cost of stranded assets that we  
15 have just been discussing. You then refer to the incidence effects of unwinding socially  
16 desirable cross-subsidies. What socially desirable cross-subsidies are we talking about?

17 A. Well, we might be talking about, for example, the regional averaging of charges to all  
18 household customers which provides a degree of protection to those customers in areas  
19 which are more costly to supply, which may include rural areas, for example.

20 Q That is household customers? A. Yes.

21 Q If we just jog back to the consultation paper - we can look at it, but just let me draw your  
22 attention to two passages in that paper, which are not, I think, quoted in the witness  
23 statement at the moment ---- Paragraph 28 says, in relation to competition for large users,  
24 “Unlike household customers, costs subsidies have been largely unwound”. A. That  
25 is a reference to cross-subsidies as between the non-household customers as a class on the  
26 one hand, and household customers as a class on the other hand. In terms of the reference  
27 to there being continued cross-subsidies with household customers, I think that is probably a  
28 reference to the fact that most household customers remain unmetered. They pay a charge  
29 according to the rateable value of their property, which, of course, bears no direct relation to  
30 the cost of supplying them.

31 Q I can understand that there may well be some sort of cross-subsidies within the household  
32 class for all sorts of reasons – social and otherwise. I think a little later on – at 176 I the  
33 paper – “However, OFWAT believes there are no significant cross-subsidies between  
34 eligible and ineligible customers”. A. Yes. In effect that is saying that we think that

1 on the whole tariffs for commercial customers reflect the lower costs of supplying  
2 commercial customers relative to the costs of supplying household customers.

3 Q Yes. So, going back to the witness statement on p.10, how does the consideration of the  
4 incidence effects of unwinding socially desirable cross-subsidies still play in relation to  
5 large industrial customers? A. Sorry. If I can take a moment just to re-read ---- (After  
6 a pause): Sir, that refers specifically – if we are talking about the paragraph following (b)  
7 ‘Protecting Customers’ ---- That does refer specifically to customers who are unable to  
8 benefit directly from common carriage or retail competition; that they should be protected  
9 from the possible costs of such competition.

10 Q But, the White Paper says there are no significant cross-subsidies between eligible and  
11 ineligible customers. A. At present, yes.

12 Q Well, can we assume the consultation paper ---- that what the consultation paper says is  
13 correct? A. Yes, we can. I think what the consultation paper was getting at – and here I  
14 am second-guessing what DEFRA were attempting to say ---- I think what it was getting at  
15 was that there may be a risk if new entrants in the water industry are allowed to come in and  
16 compete, and if by doing so they were to leave the incumbent undertaker with stranded  
17 assets, then the cost of those assets would still have to be financed, and DEFRA’s view was  
18 that the financing of those stranded assets should not fall to ineligible customers – as  
19 eventually they could do.

20 Q Can we park the stranded assets for a moment, because I think we have just been on that? I  
21 am on the next bit – the socially desirable cross-subsidies. What I am struggling with at  
22 the moment is whether, and if so in what sense, there are any ‘socially desirable cross-  
23 subsidies[‘ in relation to large industrial customers. A. That, I think, would be a  
24 reference to the risk that with certain approaches to access pricing undertakers would be  
25 encouraged regionally to de-average their tariffs for commercial customers. In so doing,  
26 they may feel that it then necessarily follows that they should be de-averaging their tariffs to  
27 all customers. So, in that sense, there would be a knock-on consequence for household  
28 customers.

29 Q But, at the moment, it is only open to customers above 50 megalitres. A. Yes.

30 Q So, there is a sort of psychological thing that you do not want it unravel into the household  
31 sector. A. That is right. I think the idea is that once you start unravelling for those  
32 above 50 megalitres, it becomes difficult not to do so equally for those below 50. If you  
33 imagine a customer who is using 49 megalitres a year, for example, who is subject to a  
34 regionally averaged tariff, it may end up with an incentive to consume an extra megalitre of

1 water in order to qualify for the regionally de-averaged tariff, which is lower for its zone. It  
2 could actually, in effect, save money by using more water – which would be perverse and  
3 not something we would regard as desirable.

4 Q Doesn't the very idea of allowing competition in, even if it is in a limited way on an ECPR  
5 process, but presumably it is done in the expectation that some competition will take place -  
6 --- It is said to encourage it. That is your evidence. If that is going to encourage  
7 competition, and there is going to be some competition as apparently we all hope, then that  
8 is going to begin to undermine regional averaging in the sector where that competition is  
9 allowed to take place, is it not? A. Well, it wouldn't do with the efficient component  
10 pricing rule, no.

11 Q Why not? If someone can produce a cheaper source, he will produce a price that is a bit  
12 lower than the tariff. A. It will indeed result in regional de-averaging for the customer  
13 who is being supplied by the new entrant, but there is no reason for the incumbent water  
14 company to de-average its tariffs.

15 Q No. But, once you start this process ---- once a new entrant comes in you will have a  
16 situation in which it is no longer the case that all customers are paying the regional average  
17 because someone will be paying lower than the regional average. A. That is true, yes.

18 Q To that extent at least regional averaging will be qualified, weakened, or whatever, by the  
19 effect of competition. A. Yes.

20 Q And may result, I suppose, in some sort of re-assessment by incumbents of their pricing  
21 policies or greater efficiency, or something that will have a sort of continuing effect. A.  
22 It might do, but the point of the efficient component pricing rule was that it provides no  
23 incentives for the incumbents to pre-empt this process by regionally de-averaging their  
24 tariffs. They have no need to do so because the access price is calculated by taking the  
25 regionally averaged tariff as the starting point, and then subtracting the actual location-  
26 specific avoidable costs – ARROW costs. So, there is no need to regionally de-average  
27 your final tariffs to your commercial customers in order to pre-empt competitive entry ----

28 Q So, the people who do better than the average are those who can benefit from competition,  
29 are they not? A. Yes.

30 Q Everybody else stays where they are. A. Yes.

31 Q Can we understand a little better regional averaging and how it works in relation to these  
32 very large customers that we are talking about in this case, most of whom historically have  
33 been, for many years, on special agreements – although there has been a sort of recent move  
34 across? What is the underlying rationale for regional averaging in relation to these very



1 large customers? A. It basically follows from companies' Condition E – Condition E  
2 of their Conditions of Appointment, which requires that they be shown neither undue  
3 preference, nor undue discrimination in their charges. So, our view has always been that  
4 they should charge customers according to the customer's characteristics rather than to the  
5 characteristics of the location. So, a given customer with the same characteristics should  
6 receive the same charge whatever its location.

7 Q Let us stick with these large customers for the time being. Does regional averaging for  
8 those large customers imply some cross-subsidy between industrial customers? A.  
9 Yes, it does, yes.

10 Q i.e. that the costs of serving some of those customers are lower than the costs of serving  
11 other customers, however we get at the costs – by some mechanism. A. Yes.

12 Q We know it is difficult, but ---- A. To the extent that costs do differ between all zones,  
13 then, yes.

14 Q Isn't charging somebody the same price if the costs are different as much undue  
15 discrimination as charging them different prices when the costs are the same? A. Then  
16 we come back to the point that I was making about the gradual unwinding for the remainder  
17 of the customer base.

18 Q Customers are different, how does Condition E prevent them being charged different prices  
19 that are more reflective of their individual cost? A. Sorry, could you repeat the question?

20 Q Yes, we have got a hypothesis in which, apparently, the costs of supplying these various  
21 large customers – let us deal with the top 10 for argument's sake – are apparently different,  
22 there are some cross subsidies between the various customers, and the point I am putting,  
23 which will no doubt be a question of argument and all the rest of it, but you are the only  
24 representative of OFWAT we have so in fairness I have to put it to you, is it not undue  
25 discrimination to charge two customers the same price when the costs of serving them are  
26 different? A. I think what we have said in the past is that it is the companies to come to  
27 us if they wish regionally to de-average their tariffs for business customers then they would  
28 need to come to us with the costs' justification for doing so, but in default of that we are  
29 comfortable with the notion that customers should pay regionally averaged charges.

30 Q So on your view, to put it rather ---- A. But it is possible.

31 Q -- in a rather basic way, if we take these large, non-potable customers, you are comfortable  
32 with the possibility that the paper mill is subsidising the steel works, which is subsidising  
33 the oil refinery, or vice versa? A. With the principle, yes. I do not know the facts.

1 Q The principle that these various organisations should be subsidising each other is one you  
2 are comfortable with? A. That is what happens, yes.

3 Q It may be what happens, but what is the policy justification for that? Why should a steel  
4 works in the South subsidise a paper mill in the North or vice versa? A. It is, as I say, the  
5 fact that once you start unwinding for the industrial customers, the question becomes where  
6 do you stop? An example of the customer using 49 megalitres per year who may be  
7 incentivised to use a little more in order to save money if regionally de-averaged charges  
8 only extended to customers outside ----

9 Q So it is a “where do you stop?” point? A. Yes.

10 PROFESSOR PICKERING: What about the views of the customers? The Enterprise Act was  
11 preceded by a White Paper that I think we understood really came from the Treasury about  
12 the competition policy was very important for Britain’s economic performance. Now, if  
13 you have a large customer who is very dependent on water as an input, then if that customer  
14 is subsidising and therefore paying a higher price than the real costs of supplying, then the  
15 implication is that that puts that customer in England or Wales at a disadvantage, maybe  
16 relative to its international competitors. That may therefore cost us sales, it may actually  
17 give rise to closure of a UK plant to the advantage of plants elsewhere in the world. Does  
18 that enter OFWAT’s thinking? A. It is not something that we have actually discussed.

19 Q I am amazed.

20 THE PRESIDENT: Could I just, on the last topic, Mr. Hope, you have been very patient, so  
21 thank you very much for your help, go back to this basic point. What the new entrant under  
22 ECPR has to play with is the avoided costs of the incumbent, of course he has his own  
23 overheads to pay for as well. He has his own fixed costs. He is also holding harmless the  
24 incumbent whose profits remain the same under this theory. So is it not the case that the  
25 new entrant is effectively bearing two sets of overheads, his own and the incumbents? In  
26 those circumstances would a new entrant have to be not merely as efficient as the incumbent  
27 but super efficient in order to make any realistic stab at entering in an effective way?  
28 Would that be a fair way of putting it? A. I think it would. It is perfectly possible that  
29 you could have a side by side comparison comparing the costs of supplying a particular  
30 customer, say a particular large user customer; you could see a potential entrant being able  
31 to make that supply at lower cost than the incumbent. But if the outcome is that the total  
32 cost of supplying all customers, not just the customer who is subject to competition, but if  
33 the cost of supplying all customers would be higher in the event of entry then that is

1 something that the efficient component pricing rule and, we think, the cost principle would  
2 prevent.

3 Q But why should the costs go up to all customers? A. In the event that entry which raises -  
4 ---

5 Q Well let us take a simple example. As I have understood it. We have two equally efficient  
6 competitors, i.e. a new entrant and incumbent, and they have both got a similar overhead  
7 structure, even so the new entrant is marginally more efficient. In normal circumstances  
8 that would be the entry of an efficient firm into the industry. He manages to get a customer.  
9 We have some competition starting that might be seen to be a good idea, certainly if we are  
10 thinking about the 1998 Act, probably also under the O3 Act. That cannot really happen  
11 under ECPR, because it is quite a narrow margin, the avoided costs he has to play with.  
12 Then I think, so the argument runs, if you did have a firm that was more efficient coming in  
13 (or equally efficient) even though that firm was equally efficient that might load some other  
14 costs on to other customers, that is the argument? A. Yes.

15 Q There are two things, I suppose – well they come down to one thing I suppose that worries  
16 one, why is it assumed that with that sort of entry the incumbent necessarily needs to raise  
17 his prices to everybody else as distinct from increasing his efficiency or taking perhaps even  
18 a marginally less profit whilst still remaining financially healthy? A. It is not  
19 automatically assumed. I think we said in MD163 that we would look to incumbent  
20 undertakers to find alternative uses for their assets and to become more efficient, etc. But  
21 ultimately we have a duty to ensure that companies can finance their functions and to the  
22 extent that they are unable to reduce these costs or avoid the costs of stranded assets, then  
23 those are functions that need to be financed, and the knock on effect for other customers  
24 comes through the price review process, which occurs every five years. In the intervening  
25 period an undertaker might well make and absorb a loss as a result of an entrant coming in,  
26 but at the following price review the way we calculate price limits is by comparing on the  
27 one hand the costs that we expect the undertaker to incur over the coming five years, with  
28 the revenues that it is likely to receive. If those costs include stranded asset cost then so be  
29 it, we are taking them into account – to the extent, as I say, that we are satisfied that there  
30 genuinely is no way that they could find an alternative use for the assets or so on.

31 Q Because you mention, quite rightly, in MD 163 there is reference to incumbents increasing  
32 efficiency, and so forth, and one understands that, but if under ECPR the incumbent's  
33 profits are guaranteed, whatever happens, is there any real pressure on the incumbent to

1 increase efficiency? A. There is, of course, the incentive to become more efficient in  
2 order to make greater profits ---

3 Q From the incentive built into the general price scheme? A. Yes.

4 Q Yes, I see. Well I think we will probably leave it there, thank you very much, Mr. Hope.  
5 There may be some more questions arising out of that from your counsel. Thank you very  
6 much for your help. A. Thank you.

7 Re-examined by Mr. ANDERSON

8 Q Just one or two questions. If I could just go back to this question of stranded assets. I  
9 understand your answer on the question of bypassed assets, because if you build a  
10 completely separate parallel network you are not going to be seeking access from the  
11 stranded assets, and that is just a hint that the owner of that asset takes. But perhaps you  
12 could explain to the Tribunal how it would happen if there were partially stranded assets,  
13 what is the mechanism for it finding its way into the ECPR calculation? Assuming you  
14 have got, I do not know, a 3p resource cost, some of it is avoidable, some of it is stranded,  
15 because you do not need some particular aspect of what your original supplier provided to  
16 you, how does that calculation then operate under ECPR? A. Well, if some of it is  
17 stranded it is not being subtracted from the retail price in order to calculate the access price;  
18 hence the access price is correspondingly higher than it otherwise would be, even if the  
19 stranding is partial.

20 Q And that is because it is not avoidable? A. Indeed.

21 Q Right. If taking hypothetically this example, Albion and Shotton went bust and closed  
22 down, Welsh would have some stranded assets. They would no longer be obtaining an  
23 access price because there is no longer a supply happening, it is just a stranded asset, what  
24 happens in that situation? How does Welsh, if at all, compensate itself for stranding in those  
25 circumstances? A. Sorry, the scenario is that Albion Water ceases to supply Shotton.  
26 Who, in this scenario, is supplying Shotton instead?

27 Q Nobody, they are just plain stranded assets, that Welsh wakes up one day and finds we have  
28 got these treatment works and pipes we can no longer put them to any use because there is  
29 no supply occurring? A. That is precisely the kind of scenario that companies encounter  
30 all of the time in the sense that business customers go out of business. The incumbent water  
31 companies lose the revenue from those customers and unless those revenue losses trigger an  
32 interim determination of price limits then the company simply absorbs those losses until the  
33 next price review.

1 PROFESSOR PICKERING: And what happens at the next price review? A. At the next price  
2 review price limits will be set to ensure that the companies can finance their functions but  
3 again we will be challenging the companies to find greater efficiencies and to find  
4 alternative uses for any assets that might be stranded, and also that would include re-  
5 allocating water, selling water through bulk supplies to neighbouring companies that might  
6 need it more.

7 THE PRESIDENT: And obviously in the postulated example there would be some savings as  
8 well? A. Yes.

9 Q Water is spare and staff you could reduce and so forth and so on? A. Yes.

10 PROFESSOR PICKERING: But if the asset stayed unused for four years and, at the point of the  
11 next price review, was still unused, would the determination of the overall price for revenue  
12 allowable to that company include a provision for the remuneration of that unused capital  
13 asset? A. Yes.

14 Q Indefinitely? A. Not necessarily, it would depend; OFWAT makes a judgment on  
15 whether the stranding of any assets has resulted from poor management on the part of the  
16 undertaker concerned, or whether it is from factors outside of the undertaker's control. If it  
17 has resulted from poor management then there is no obligation to finance that asset.

18 MR. ANDERSON: Seeking an alternative use might be one way forward for them? A. Yes.

19 Q Although, given that these pipes are where they are that might not always be possible, I  
20 suppose? A. But if our view was that there was an alternative use and the company had  
21 failed to ensure that the assets were allocated to meeting that alternative use then we would  
22 not make allowance in setting price limits recovering the costs of the asset.

23 MR. ANDERSON: Thank you very much.

24 THE PRESIDENT: Thank you. I think we will adjourn at that point. We are not getting on  
25 particularly well as far as time is concerned at the moment, are we, Mr. Thompson? I am  
26 just concerned a bit about our expert witnesses, Mr. Anderson, we are spending a lot of time  
27 here dealing with things that are not directly in their bailiwick and I am just wondering if we  
28 should perhaps try and do the expert evidence tomorrow rather than Mr. Jones, and come  
29 back to Mr. Jones on Monday, and I am not sure whether we can even get through the  
30 experts in a day?

31 MR. ANDERSON: I have no idea how long Mr. Jones will take. I would have thought we would  
32 certainly get through the experts in a day, probably less than that?

33 THE PRESIDENT: What is your view, Mr. Thompson, Mr Vajda, Mr. O'Reilly?

1 MR. THOMPSON: I think the most uncertain thing is how long Mr. Vajda is anticipating his  
2 examination-in-chief of Mr. Jones to be. He was threatening half a day yesterday, which  
3 seemed long to me but at lunch time he was suggesting that we might let Mr. Jones go this  
4 afternoon, which obviously proved optimistic.

5 In terms of the experts, I have one or two questions for Dr. Marshall, and probably slightly  
6 longer than I have with Mr. Hope for Professor Armstrong, but that suggests that unless  
7 anybody else has a great deal of cross-examination we will comfortably deal with both the  
8 experts in a day.

9 THE PRESIDENT: Do you agree with that, Mr. O'Reilly, as far as you know?

10 MR. O'REILLY: Yes, we are going to co-ordinate questioning of Professor Armstrong so I  
11 should imagine I shall only be a few moments, really.

12 THE PRESIDENT: Mr. Vajda, would it be more convenient to try to do the experts tomorrow,  
13 because we are not sitting on Friday, and that would just leave Mr. Jones for next week?

14 MR. VAJDA: There is a balancing exercise in that Mr. Jones has also been here.

15 THE PRESIDENT: Yes, but he is a party and the others are not parties.

16 MR. VAJDA: Yes, I accept that. What I can say in the light of – I was not threatening anybody  
17 in terms of my examination of Mr. Jones, I have very much in mind what you, Sir, have said  
18 to me and how the case has gone – I am not now planning to be two hours. There will still  
19 be some examination but I would anticipate it would be somewhere between half an hour  
20 and 45 minutes.

21 THE PRESIDENT: In chief?

22 MR. VAJDA: In chief, yes.

23 THE PRESIDENT: It is true. It is not normally necessary to bring out things in chief in this  
24 Tribunal. You can take us quickly to the paragraphs, and we can note them, and carry on.  
25 We have read it all several times now.

26 MR. VAJDA: Yes, but there are particular points ----

27 THE PRESIDENT: What is your preference? You may have to ask Dr. Marshall and Professor  
28 Armstrong what their preferences are. I think you will.

29 MR. VAJDA: I think what is being said by those behind me is if Mr. Jones could start tomorrow  
30 morning ---- Obviously there is a balancing exercise to be done. I do not know how long  
31 Mr. Thompson is going to be. I can see that one would want to be confident that one would  
32 get through the experts as well tomorrow. I think so far as the cross-examination of Dr.  
33 Marshall is concerned, so far as I am concerned, I would not anticipate that I would be  
34 longer than an hour.

1 THE PRESIDENT: Perhaps we could ask Dr. Marshall and Professor Armstrong whether they  
2 have got any preferences?  
3 MR. THOMPSON: I am happy for them to do it directly, but I did ask Dr. Marshall whether she  
4 was available on Monday. She is available on Monday. So, there is no particular problem if  
5 we carry on with the current batting order.  
6 THE PRESIDENT: Dr. Marshall, what is your general position. Would you be happy to come  
7 back on Monday?  
8 DR. MARSHALL: Yes, I am happy to fit in.  
9 THE PRESIDENT: Right. Professor Armstrong? I am sorry you have been listening to quite a  
10 lengthy debate about some fairly arcane subjects. Would you be able to be available both  
11 tomorrow and Monday, if necessary?  
12 PROFESSOR ARMSTRONG: Yes.  
13 THE PRESIDENT: If there is no objection from the experts, then I think we will go on with Mr.  
14 Jones.  
15 MR. VAJDA: I am very grateful. Obviously, he is the client. He has a business to run.  
16 THE PRESIDENT: We get the direct fact out of the way, and then we can get on to the more  
17 complicated matters. But, we may not get through both expert witnesses tomorrow as far  
18 as I can see.  
19 MR. VAJDA: As far as I understand it, we are dealing with Professor Armstrong first; is that  
20 right? That is my understanding.  
21 THE PRESIDENT: I would have thought, in the normal course, it is for the Appellants to call  
22 Dr. Marshall and for the Respondents to cross-examination Dr. Marshall.  
23 MR. THOMPSON: I think it was agreed that Professor Armstrong would go first.  
24 THE PRESIDENT: We will proceed on those lines. Ten-thirty tomorrow. Thank you very  
25 much everybody.

26  
27 (Adjourned until Thursday, 1 June, 2006 at 10.30 a.m.)  
28