Neutral citation [2005] CAT 40

**IN THE COMPETITION APPEAL TRIBUNAL**

Case No: 1046/2/4/04

Victoria House
Bloomsbury Place
London WC1A 2EB

22 December 2005

Before:

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

Sitting as a Tribunal in England and Wales

BETWEEN:

**ALBION WATER LIMITED**

Appellant

supported by

**AQUAVITAE (UK) LIMITED**

Intervener

-v-

**DIRECTOR GENERAL OF WATER SERVICES**

Respondent

supported by

**(1) DŴR CYMRU CYFYNGEDIG**

and

**(2) UNITED UTILITIES WATER PLC**

Interveners

# INTERIM JUDGMENT

## APPEARANCES

Dr Jeremy Bryan, Managing Director of Albion Water Limited, and subsequently Rhodri Thompson QC and John O'Flaherty appeared on behalf of the appellant, Albion Water Limited.

Michael O'Reilly (instructed by McKinnells, Leicester) appeared on behalf of Aquavitae (UK) Limited.

Rupert Anderson QC and Valentina Sloane (instructed by the Head of Legal Services, OFWAT) appeared on behalf of the respondent.

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

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

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## I SUMMARY

1. Albion Water Limited ("Albion") appeals against decision CA98/01/2004 dated 26 May 2004 (the "Decision") of the Director General of Water Services (the "Director"[1]) to the effect that Dŵr Cymru Cyfyngedig ("Dŵr Cymru") has not infringed the Chapter II prohibition set out in section 18 of the Competition Act 1998 (the "1998 Act") in relation to the price offered by Dŵr Cymru to Albion for the "common carriage" of non-potable water[2] across a part of Dŵr Cymru's water transportation network known as the Ashgrove system. The Ashgrove system, on Deeside, serves Albion's only customer, Shotton Paper Mill ("Shotton Paper") as well as Corus Group ("Corus"), which is a customer of Dŵr Cymru.

2. This case raises important issues regarding the application of the Chapter II prohibition, and the interaction between the 1998 Act and the Water Industry Act 1991 (the "WIA91"), in relation to arrangements for the supply of non-potable water to the very largest industrial customers. Partly as a result of the fact that Albion was, initially, represented by its Managing Director acting in person and that certain highly relevant disclosure was sought and given only at a relatively late stage, in our view some of the main issues began to come into focus only at the main hearing.

3. Having, since the hearing, considered in detail the extensive material now before the Tribunal, we consider for the reasons given below that there are certain issues on which this matter should be restored for further directions before we reach a final judgment.

4. First, there is one central factual issue that it would be unsatisfactory to decide without further evidence, namely whether, as the Director maintains, the cost of the bulk distribution of non-potable water is the same as the cost of distribution of potable water.

[1] In this judgment "Director" refers to the office and not to any particular individual.
[2] The quality of water supplied to Shotton Paper by Dŵr Cymru is discussed later in this judgment. Non-potable water is, essentially, water that is of insufficient purity to be used as drinking (i.e. potable) water. Non-potable water may be partially treated or "raw" (i.e. untreated) water but the parties are in dispute as to whether the partially treated non-potable water in issue is much different from "raw" water in a reservoir.

5. Secondly, we would wish to hear argument on whether we should have further evidence as to costs of non-potable water supply, including the costs of the Ashgrove system.

6. Thirdly, the workings and implications in the present case of an economic principle known as the Efficient Component Pricing Rule ("ECPR"), which is a central issue, were in our view not ventilated at the hearing in sufficient detail to enable us fairly to decide that issue under the Chapter II prohibition without giving the parties an opportunity to address us further on the matters which we have provisionally identified in that regard, set out in detail later in this judgment.

7. In that context, on the issue of the alleged "margin squeeze" in this case, for the reasons given below, we do not at present find ourselves able to accept the Director's submission that there is no basis for Albion's submissions, but equally at present we do not feel able to accept Albion's submissions on this issue, at least until we have heard further argument. The margin squeeze issues are closely interrelated with the ECPR issue, and we would not wish to decide those two issues separately.

8. In those circumstances this judgment is an interim judgment which sets the framework in which we envisage deciding the remaining issues in what we anticipate being a relatively short final stage. We will also hear argument from the parties on the procedural steps that should now be taken, including the filing of any further evidence. Any views expressed on the outstanding issues in this judgment are provisional.

9. The question of the relationship between the 1998 Act and the WIA91 and the construction of section 66E of the WIA91 will be dealt with as far as necessary in the final judgment.

## II INTRODUCTION

*The main participants*

10. Albion was granted what is known as an "inset appointment" pursuant to section 7(5) as amended of the WIA91 on 1 May 1999. That appointment entitles Albion to supply water within the area referred to in the appointment. In Albion's case the area in

question covers, in effect, the premises of Shotton Paper. We understand that Albion is the only licensed new entrant inset appointee in the water industry since the privatisation of the industry in England and Wales in 1989.

11. At the time of its inset appointment Albion was the wholly-owned subsidiary of Enviro-Logic Limited ("Enviro-Logic") which, in turn, was 50% owned by Pennon Group plc ("Pennon") and 50% by individuals including Dr Jeremy Bryan, the Managing Director of Albion, under a joint venture agreement. Pennon is the holding company of South West Water Limited, a statutory water and sewerage undertaker serving Devon, Cornwall and adjacent areas. In 2003 Pennon acquired 100% of the shares in Enviro-Logic, which changed its name to Peninsula Water. On 19 February 2004 Waterlevel Limited, a new company set up by Dr Bryan, acquired Albion from Pennon.

12. Shotton Paper is a paper mill established in 1985 on Deeside. It is owned by UPM-Kymmene (UK) Limited ("UPM"). UPM is part of a publicly quoted Finnish group operating worldwide. Shotton Paper produces newsprint and, according to the Decision, uses an average of approximately 6,600Ml of non-potable water[3] in its production process annually. This case concerns the supply of non-potable water to Shotton Paper for paper making.

13. To get some idea of the order of magnitude, Albion told us that the volume of water consumed by Shotton Paper is equivalent to the consumption of about 35-40,000 domestic customers, i.e. a medium sized town. In broad terms Shotton Paper pays Albion about £1.7 million per annum for supply of the water in question. A difference of 1p/m³ in the common carriage price paid by Albion to Dŵr Cymru represents revenue of approximately £66,000 per annum.

14. Dŵr Cymru is a statutory undertaker providing water and sewerage services in Wales and some adjoining areas of England, which took on the functions of the previous Welsh Water Authority at the time of privatisation in 1989. Dŵr Cymru is ultimately owned by Glas Cymru Cyfyngedig, a not-for-profit company limited by guarantee which was established for the specific purpose of acquiring and owning Dŵr Cymru. In 2002/2003 Dŵr Cymru's total turnover was some £457 million.

[3] The unit is a megalitre. One megalitre is 1000 cubic metres or 1,000,000 litres.

15. United Utilities Water plc ("United Utilities") is a statutory undertaker providing water and sewerage services to customers in North-West England. Pursuant to Heads of Agreement dated 10 May 1994, Dŵr Cymru purchases a "bulk supply" of water from United Utilities, for onward sale to Dŵr Cymru customers via the Ashgrove system. This agreement is referred to in the Decision as the "First Bulk Supply Agreement".

*History of the Ashgrove system*

16. The Ashgrove system was constructed in the 1950s by Birkenhead Corporation, a predecessor of North West Water, now United Utilities. Essentially, the water is abstracted from the River Dee at Heronbridge, and then pumped to the Ashgrove water treatment plant. From there the water descends by gravity through the 600mm Ashgrove pipeline which covers a distance of some 15 kilometres as the crow flies, but, we are told, is nearer 21 kilometres in total length. The pipe splits in half at one point to go under the River Dee. The Decision (paragraph 157) assumes that the length is 15 kilometres, although a United Utilities figure referred to in the Decision states the length to be 17.4 kilometres.

17. When originally constructed, the Ashgrove pipeline supplied non-potable water to the water treatment works at Sealand, which is on what is now the Shotton Paper site. At Sealand the water was treated to a potable standard for onward supply to consumers. At the same time the Ashgrove pipeline also supplied non-potable water to the neighbouring steelworks owned by British Steel, Corus' predecessor, and to a third customer no longer in business.

18. Shotton Paper sought a non-potable water supply from North West Water in 1984. Around the same time, North West Water decided that it no longer needed to supply potable water from the Sealand treatment works, so the Sealand plant was decommissioned and the site sold to Shotton Paper. Since the late 1980s the Ashgrove system has supplied non-potable water only to Shotton Paper and to Corus[4].

[4] We understand from a letter to the Director from Dŵr Cymru dated 30 July 2004 that Corus has also been in dispute with Dŵr Cymru as to the latter's charges, but we have no details of this dispute. It appears from that letter that Corus had been withholding payments of over £1 million a year.

19. The Ashgrove system (but not the Heronbridge pumping station) was transferred from North West Water to the Welsh Water Authority, Dŵr Cymru's predecessor, in about 1986 prior to privatisation. North West Water, as we have said, is now part of United Utilities.

*The present situation*

20. The water intended for the Ashgrove system is abstracted from the River Dee by United Utilities at the Heronbridge pumping station. At a water meter a short distance from the pumping station, the water passes into the Dŵr Cymru supply area, from where it is pumped a short way to the Ashgrove water treatment plant. The price paid by Dŵr Cymru to United Utilities is governed by the First Bulk Supply Agreement, mentioned above, which essentially contains a cost-sharing formula. Dŵr Cymru takes about 20 per cent of the water abstracted at Heronbridge[5] and is liable to pay a proportion of United Utilities' costs.

21. At the Ashgrove water treatment plant aluminium sulphate is added to the water, which then passes through sedimentation tanks called clarifiers. The various solids and particulates in the water react with the aluminium sulphate and coagulate to form a "sludge blanket" within each clarifier. This blanket effectively acts as a filter. As the water passes through each sludge blanket, the solids and particulates are progressively filtered out into the sludge, which is periodically removed. According to Albion, the main purpose of this treatment is to reduce the risk of sedimentation in the Ashgrove pipeline through which the water subsequently flows.

22. There is no agreed description of the quality of the water leaving the Ashgrove treatment works. Albion contends that the treatment process is relatively simple, equivalent to no more than the use of a reservoir where solids and particulates settle on the bottom. According to Albion, the resulting water quality is of the lowest recognised grade, and Albion's supply agreement with Shotton Paper requires no particular quality. The bulk supply agreement between Albion Water and Dŵr Cymru dated 10 March

[5] The balance of the water abstracted at Heronbridge is used by United Utilities to supply its customers in the Wirral and elsewhere.

1999, referred to in the Decision as the "Second Bulk Supply Agreement" provides at paragraph 1.4 that:

> "No particular quality of water will be guaranteed but the source of supply will be River Dee water settled at Ashgrove Treatment Works with chemically assisted coagulation determined by raw water conditions."

In addition, a letter from Dŵr Cymru to Enviro-Logic dated 1 July 2002 indicates that "the raw water supplied to you by this company will frequently be fluid category 5". This is the lowest quality of water identified in the Water Supply (Water Fittings) Regulations 1999, SI 1999/1148[6].

23. The Director, however, considers that the water concerned is properly to be considered as "partially treated" water as distinct from "raw" water. According to the Director, the treatment at Ashgrove removes more of the smaller solids than would be the case with a reservoir.

24. The operation of the flow through the Ashgrove pipeline is maintained and controlled telemetrically 24 hours a day through Dŵr Cymru's control room at Bretton[7]. Shortly before the Ashgrove pipeline reaches the Sealand site, it divides at a "rotork" valve which controls the supply to Shotton Paper and Corus respectively. Shotton Paper's demand varies in accordance with the needs of its production process. When Shotton's demand is lower, Dŵr Cymru uses the rotork valve, controlled telemetrically from Bretton, to divert more water into storage lagoons, owned by Corus. The Corus lagoons thus perform a flow-balancing function.

25. At present, Albion purchases the water in question under the Second Bulk Supply Agreement from Dŵr Cymru (which has in turn purchased the water from United Utilities) at the boundary of Albion's inset appointment area at the premises of Shotton Paper. The meter is situated at the disused Sealand treatment works.

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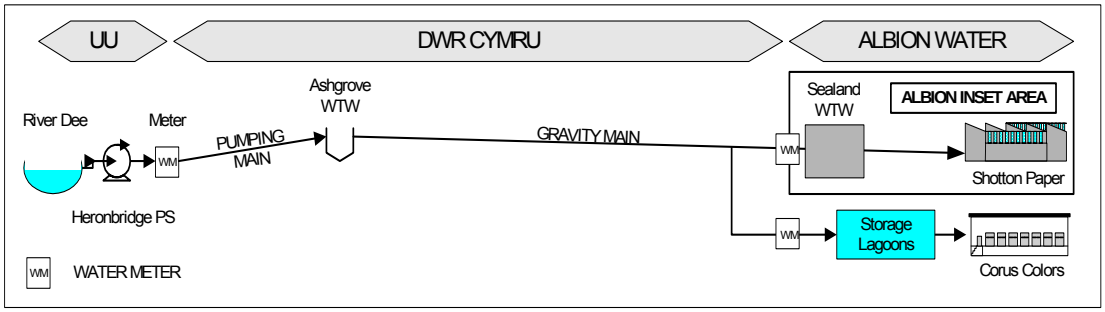
[6] For the purposes of those regulations Fluid Category 5 is described as "fluid representing a serious health hazard because of the concentration of pathogenic organisms, radioactive or very toxic substances, including any fluid which contains (a) faecal material or other human waste; (b) butchery or other animal waste; or (c) pathogens from any other source".

[7] The water treatment works at Bretton also supplies potable water to Albion, for onward supply to Shotton Paper. This supply is via a separate system. Under its inset appointment, Albion is the supplier to Shotton of both potable and non-potable water, but the issue in this case relates only to non-potable water.

26. The supply agreement between Albion and Shotton Paper is dated 19 March 1999. Albion understands that it is one of Dŵr Cymru's largest customers, Shotton Paper having previously been one of Dŵr Cymru's largest customers. The figures before the Tribunal suggest that Shotton Paper is the second largest industrial user of water in Wales[8].

27. According to Albion, the present arrangement may be shown in diagrammatic form as follows:

**Figure 1 The Ashgrove System – current operation**

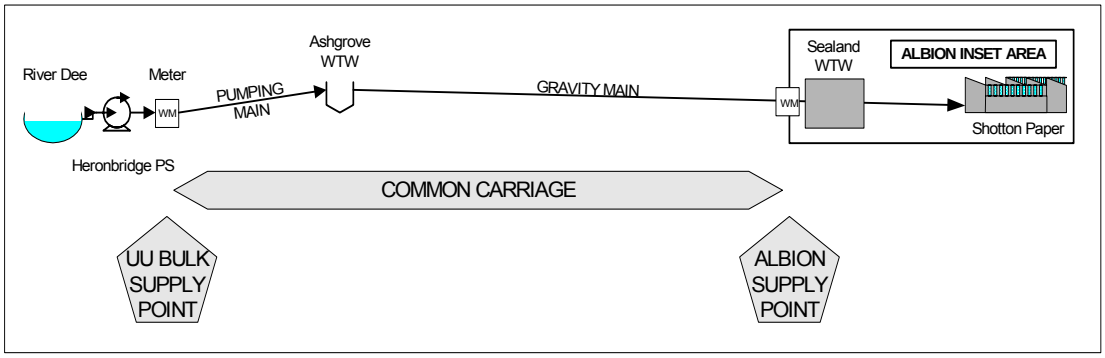



*What Albion wishes to do*

28. What Albion wishes to do, in broad terms, is to acquire the water in question directly from United Utilities at Heronbridge, and then resell the water to Shotton Paper, paying a common carriage charge to Dŵr Cymru for the transport of the water to Shotton Paper via the Ashgrove System. In effect, Albion wishes to replace Dŵr Cymru as the intermediate supplier between United Utilities and Shotton Paper to the potential benefit, says Albion, of Shotton Paper, United Utilities, and Albion itself.

29. Albion's proposal can be shown in diagrammatic form as follows:

**Figure 2 Albion's proposal**




[8] Document 5/25 annexed to the Notice of Appeal.

30. Albion considers that, if the common carriage price is calculated on what Albion considers to be a reasonable basis, Albion should be able to negotiate to purchase the water from United Utilities, and resell the water to Shotton Paper at a price lower than the price that Shotton Paper is currently paying for its water, while at the same time earning a margin for Albion. According to Albion, such a margin would exist even if Albion were to pay United Utilities a price higher than the price United Utilities currently receives from Dŵr Cymru. This result, according to Albion, is achievable because of the allegedly extremely high margin which Dŵr Cymru presently receives between the price Dŵr Cymru pays United Utilities for the water under the First Bulk Supply Agreement, and the price which Dŵr Cymru receives from Albion for the water ultimately supplied to Shotton Paper: for the figures, see below.

31. The viability of Albion's proposal, however, is highly dependent on the level of the common carriage price to be charged by Dŵr Cymru for the transport of the water in question. It is the alleged failure of Dŵr Cymru to offer what Albion considers to be a reasonable common carriage price, and the Director's finding in the Decision that the common carriage price offered by Dŵr Cymru did not constitute an abuse of a dominant position within the meaning of the Chapter II prohibition, which form the subject matter of this appeal.

## III HISTORY AND BACKGROUND

*The original inset appointment*

32. Inset appointments for large user customers were introduced by the Competition and Service (Utilities) Act 1992, as a means of introducing an element of competition in the supply of water. Albion applied to the Director for an inset appointment to supply Shotton Paper in February 1996. According to Albion, this was at Shotton Paper's request.

33. According to the Decision, Albion informed the Director at that time that it intended to develop an alternative source of water with which to supply Shotton Paper, at a site called the Milŵr Tunnel. The Milŵr tunnel is a tunnel constructed many years ago running from Boot End, near Bagillt, on the Flintshire Coast ten miles inland towards

the Halkyn Mountains. The original purpose of the tunnel was to lower the water table so that mining work could be carried out at greater depths. There is evidence before the Tribunal that the Milŵr Tunnel was used by Dŵr Cymru in the 1990s to supply water to a plant near Flint belonging to Kimberley Clark.

34. A business plan submitted in connection with Albion's application for an inset appointment on 26 November 1997 envisaged the use of the Milŵr Tunnel for supply to Shotton Paper from the second half of the second year from Albion's inset appointment being granted. According to the Decision (at paragraph 36), Albion Water was granted its inset appointment in May 1999 on the understanding that it would develop and use its own source of water to supply Shotton. According to the Decision, the notice periods under Albion's inset appointment were reduced because of uncertainty as to whether Albion would be able to acquire a cheaper resource.

35. According to Albion, it could not progress with the development of the Milŵr Tunnel as a result of difficulties in obtaining access to that source following the transfer of the land to Hyder Industrial, an associated company of Dŵr Cymru which was later transferred to United Utilities. However, the Decision suggests that, in the Director's view, Albion did not progress the Milŵr Tunnel option because it considered "the common carriage option" (i.e. buying the water from United Utilities and then having it conveyed by common carriage to Shotton Paper) to be a potentially more profitable option (Decision, paragraphs 39 to 49). Albion replies that, at the time the inset appointment was granted, the Director well knew that the Milŵr Tunnel was no longer in Dŵr Cymru's ownership, and that the inset appointment was granted unconditionally[9]. We make no findings on this historical dispute, save to note that Albion's inset appointment was not subject to any condition relating to the use or development of any particular source of water. We can at present see no objection in principle to an inset appointment being made on the basis of a bulk supply.

[9] The Milwr Tunnel option would have apparently required a new pipeline (Decision, paragraph 107)

*The various prices*

36. The price which United Utilities has historically charged Dŵr Cymru for the water supplied to Dŵr Cymru under the First Bulk Supply Agreement has been around 3p/m³, and was forecast to rise to some 4p/m³ in 2003/4 (Decision, paragraph 65).

37. Up to 1999 the price being charged by Dŵr Cymru to its then customer Shotton Paper for non-potable water was some 27.47p/m³. Looked at arithmetically, and taking this particular supply in isolation, Dŵr Cymru's gross margin between the buying and selling price of the water supplied to Shotton Paper was therefore around 24p/m³.

38. As we have said, Albion took over the supply of water to Shotton Paper from Dŵr Cymru in March 1999. Pending the making of new supply arrangements with United Utilities, Albion needed to maintain the supply of water to Shotton Paper by purchasing the water from Dŵr Cymru. Negotiations between Albion and Dŵr Cymru had apparently begun well before this, in 1996, and these negotiations culminated in the Second Bulk Supply Agreement and the supply arrangements illustrated by Figure 1 above. During the course of these negotiations, Albion and Dŵr Cymru disagreed as to the price to be paid for this water. Dŵr Cymru quoted a price of 26.16p/m³ (i.e. only marginally lower than the price at which Dŵr Cymru had supplied the water to Shotton Paper). Albion made a counter offer of 11.92p/m³.

39. No agreement having been reached, Albion asked the Director to determine a bulk supply price between the parties under the provisions of section 40 of the WIA91. The Director provisionally determined, in a letter dated 12 December 1996, that a price of 26p/m³ for non-potable water should be indicated to the parties as indicative of the price the Director would determine formally. The Director stated:

> "The price for non-potable water is similar to prices charged by Dŵr Cymru for other bulk supplies."

40. The price for non-potable water of 26p/m³ was subsequently agreed between Albion and Dŵr Cymru under the Second Bulk Supply Agreement entered into in March 1999.

41. Shotton Paper preferred to enter into a supply agreement with Albion rather than Dŵr Cymru. However, according to Albion, the de facto retail price offered to Shotton by

Dŵr Cymru at that time was 26p/m³, exactly the same as the bulk supply price offered to Albion. In the supply agreement between Albion and Shotton Paper of 19 March 1999, Shotton Paper agreed to pay Albion the same price for the water as it could have obtained from Dŵr Cymru – i.e. 26p/m³.

42. This meant that, under the arrangements as initially set up, Albion was unable to earn a margin on the onward supply of water to Shotton Paper. It purchased the water from Dŵr Cymru at the boundary of its inset appointment area for 26p/m³, and sold the water on to Shotton Paper at the same price of 26p/m³. According to Albion, its then parent, Enviro-Logic, agreed to accept this situation, at least temporarily, in order to obtain the status of a water undertaker under the inset appointment, and in the belief that the matter would be open to challenge once the 1998 Act came into force on 1 March 2000.

43. Dŵr Cymru introduced a new Large Industrial Tariff (known as "LIT") for large users of potable water for the charging year 1999/2000, which was approved by the Director on the basis of information supplied by Dŵr Cymru in a letter dated 2 December 1998. This tariff effectively lowered prices to the largest industrial users and is said by Albion to have been introduced in response to the emerging threat of competition.

44. Meanwhile, Albion opened negotiations with United Utilities to be supplied directly with the water in question from Heronbridge. In November 2000 Albion agreed in principle to purchase water from United Utilities. In February 2001, United Utilities quoted a price of 9p/m³, as compared with the 3p/m³ United Utilities was then receiving from Dŵr Cymru. No agreement was in fact reached since Albion considered that the price of 9p/m³ sought by United Utilities was excessive. The Decision, however, is predicated on the basis that United Utilities is prepared to supply Albion (see paragraph 136 of the Decision).

*The alternative pipeline*

45. According to paragraphs 142 to 177 of the Decision, in around 2001 Albion and United Utilities discussed, at least in a preliminary and exploratory way, the alternative of building a duplicate pipeline from Heronbridge to Shotton Paper in order to bypass the Ashgrove system. A United Utilities report called the Boulton Report, apparently

prepared in about 2000, had rejected this option, not least on grounds of cost and inefficiency. Later emails between Albion and United Utilities of 6 December and 19 December 2001 suggest that the latter may have considered the construction of a new pipeline to be a viable option, on the basis of a "quick and dirty look". Albion apparently did not want the Director to know that this option was being examined, since Albion was arguing that the Ashgrove pipeline was an "essential facility". It appears that neither Albion nor United Utilities took the matter any further although, in the Decision, the Director concluded that the construction of a duplicate pipeline could, on various assumptions, be a viable option: see paragraphs 160 *et seq*, and Annex I of the Decision. We have not been asked to examine this part of the Decision, but proceed upon the hypothesis that the construction of an alternative pipeline is not a practical proposition.

*The First Access Price*

46. It appears to be generally accepted that there are three main elements which make up the cost of a bulk supply of water: (i) the cost of water resources themselves (i.e. the cost of extracting water from a water source such as a river or a borehole); (ii) treating the water to the required standard; and (iii) the cost of transporting water through pipes to the customer, referred to in this judgment as the distribution cost. It is the latter cost, the cost of distribution, which will typically be key in terms of applications for common carriage.

47. Albion first asked Dŵr Cymru formally for a common carriage price on 28 September 2000. In a letter dated 20 October 2000, Enviro-Logic indicated that it considered 7p/m³ to be a fair cost-reflective price for access to the Ashgrove system.

48. In a letter to the Director dated 11 December 2000, Albion lodged its first formal complaint under the 1998 Act, alleging that Dŵr Cymru had, among other things, persistently failed to negotiate a common carriage price.

49. On 16 January 2001 Dŵr Cymru provided Albion with an indicative "access" – i.e. common carriage – price of around 20p/m³. Enviro-Logic sent an e-mail to the Director on 18 January 2001 indicating that this price was unacceptable to them.

50. In a letter dated 20 February 2001, Dŵr Cymru informed the Director that it was minded to charge Albion an access price of 23.2p/m³ for the common carriage services requested, for the year 2000/2001. This price is referred to in the Decision as the First Access Price. Albion was notified of this price on 2 March 2001. Albion considered that this price was also unacceptable.

51. The way in which the First Access Price was calculated is set out in Schedule B of Dŵr Cymru's letter of 20 February 2001, headed "Breakdown of Average Cost of Water Services". The methodology by which the calculations were carried out is further elaborated in the Decision, at paragraphs 250 to 307, as mentioned later in this judgment.

*Albion's complaint of 8 March 2001 and subsequent events up to April 2003*

52. On 8 March 2001 Albion complained to the Director that the First Access Price constituted an infringement of the Chapter II prohibition and reiterated its complaint about the delay in providing that price.

53. After apparently investigating the matter for a year, including sending a notice dated 29 June 2001 to Dŵr Cymru requesting extensive information under section 26 of the 1998 Act, the Director wrote to Albion's solicitors on 4 March 2002 stating that the Director did not intend to take a decision and that he proposed to close the file.

54. According to Albion, at the May 2002 Board meeting of Enviro-Logic the Pennon directors indicated that no further funding would be provided to Enviro-Logic for capital projects. Albion contends that Pennon was concerned that an appeal to the Tribunal by Albion in relation to its dispute with Dŵr Cymru might adversely affect the interests of South West Water. Pennon, in a letter to the Director dated 28 April 2004 and copied to the Tribunal, states that the Pennon directors said at this Board meeting that Pennon would be unable to continue to provide the same level of financial support to Enviro-Logic, given that the latter was not financially successful. Pennon also considered that every effort should be made to resolve Albion's complaint without legal action before the Tribunal.

55. On 14 May 2002 Albion's then solicitors requested the Director to reconsider his decision to close the file under the then section 47 of the 1998 Act. By letter of 21 June 2002 the Director agreed to reopen the case and to reach a decision as quickly as possible. Thereafter the Director sent a number of section 26 notices to various parties.

56. In July 2002 the Department for Environment, Food and Rural Affairs (DEFRA) and the Welsh Assembly Government published a Consultation Paper entitled *Extending Opportunities for Competition in the Water Industry in England and Wales*. We refer to this document as "the Consultation Paper".

57. At a meeting with Albion on 10 September 2002, it was apparently intimated to Albion that the Director would be unable to produce a "draft" decision before May 2003, and that a "final" decision would not be available before November 2003.

58. On 10 December 2002, Pennon gave notice, as it was entitled to do under the relevant joint venture agreement, to acquire all the shares in Enviro-Logic from the founding shareholders. According to Pennon, they wished Enviro-Logic to pursue other kinds of commercial opportunity. According to Albion, Pennon did not wish Enviro-Logic to pursue the competitive activities with which this case is concerned, for fear of damaging the interests of South West Water and the relationship of the latter with the Director. We are told that from 1 January 2003 the working capital needs of Enviro-Logic were met by Dr Bryan personally. Dr Bryan told us that by April 2003 his financial resources were exhausted.

59. On 19 February 2003 the Government introduced the Water Bill in the House of Lords. That Bill subsequently became the Water Act 2003 ("the WA03").

60. In April 2003 Dŵr Cymru introduced, with the Director's approval, a new non-potable tariff, referred to in the Decision as "the New Tariff", for large users of non-potable water. At that time Dŵr Cymru had a small number of large users of non-potable water, all of whom were supplied under special agreements – i.e. non-standard agreements outside the tariff system, as permitted by the WIA91. Dŵr Cymru's intention apparently was that the large users of non-potable water who had special agreements with Dŵr Cymru would migrate to the New Tariff when the relevant

agreement expired. As we understand it, at the time of the Decision, only two non-potable large users, whose special agreements had expired subsequent to the coming into effect of the New Tariff, had agreed to pay the New Tariff.

*The attitude of the customers*

61. By May 2003, a decision had to be reached about the future of Enviro-Logic and its subsidiary, Albion. At the Enviro-Logic Board meeting of 1 May 2003 it was apparently agreed that Pennon would re-transfer at least 50 per cent of the shares in Albion to the founding shareholders (i.e. to Dr Bryan and his associates) if UPM preferred to have an independent water company, rather than a wholly owned subsidiary of Pennon, supplying the water to Shotton Paper.

62. A meeting apparently took place between Mr Baty, Managing Director of Pennon, and Mr Gale, Managing Director of UPM, on 22 May 2003. Mr Gale said that, if UPM had the choice of being served by Albion as a wholly owned subsidiary of Pennon, or being served by Albion as an independent water company, he (Mr Gale):

> "had no hesitation in making clear UPM's determination to be served by an independent water company. I was convinced that Pennon would not wish to antagonize Ofwat or its fellow water companies by fighting vigorously for greater supply security and fairer terms for Shotton Paper."
>
> (see Mr Gale's letter to the Director of 15 October 2003)

63. Following this exchange, and further contacts, in July 2003 Pennon agreed to transfer full control of Albion to Dr Bryan and his associates, through Waterlevel Limited. In the event, this transfer was not completed until February 2004.

64. Meanwhile, on 6 June 2003, the Director had supplied Albion with a "draft" decision. That document did not address the reasonableness or otherwise of the First Access Price but simply concluded that "the Ashgrove system is not an essential facility".

65. On 11 July 2003, the Purchasing Systems Manager for Corus in Wales wrote to Albion stating:

> "As I explained in our meeting on the 10 July 2003 we are very unhappy with the current situation in the water supply industry and the lack of any real competition in the established regions.

> Having raised this matter with OFWAT they suggested that your company offers a realistic alternative to the large established operators.
>
> Will you therefore please confirm that you are able to bid for the supply of water to three of our larger plants situated in Wales. Namely, Llanwern, Trostre and Shotton."

66. On 12 August 2003 Pennon (as the then owners of Albion) sent to the Director a detailed critique, prepared by Dr Bryan, of the "draft" decision sent on 6 June 2003.

67. On 20 October 2003 Mr Gale of UPM wrote to the Director in connection with Pennon's proposed transfer of the shares in Albion from Pennon to the team led by Dr Bryan. Mr Gale said:

> "I wrote to you last year underlining our support for Albion and the reasons why the partnership of UPM Kymmene and Albion Water is so important to our UK operations. I wish to reiterate that support. We are very conscious that Albion is still the only active competitor in the market and that Ofwat has consistently failed to address issues relating to the price and non-price terms of water. This gives us some serious concerns about potential conflicts of interest faced by Ofwat. An independent Albion Water under Jerry Bryan will continue to fight vigorously for a better, more competitive water industry. That will undoubtedly make Ofwat's life more difficult…
>
> I have seen the business plan for Albion Water created by Jerry Bryan and his responses to the 19 questions from Ofwat. I am very conscious that that plan is based, overwhelmingly, on the supply of regulated water services to the Shotton Paper site. I am also conscious that it assumes a continuation of the current level of support from UPM Kymmene that allows Albion Water to cover its costs whilst it fights for fairer terms from Dŵr Cymru. I wish to make it clear that UPM Kymmene is fully supportive of that plan."

68. As to "the current level of support from UPM Kymmene" referred to by Mr Gale, our understanding is that from at least the latter part of 2003 UPM made a financial contribution to Albion of 3p/m³ to cover Albion's running costs, including the work necessary to bring its complaint under the 1998 Act against Dŵr Cymru to a conclusion. At that stage it was apparently anticipated that the Director would reach a decision in November 2003, and that any subsequent appeal to the Tribunal would be concluded by June 2004.

69. Under the arrangements between Albion and UPM, as further confirmed by letters to the Director from Mr Gale of 10 December 2003 and 18 February 2004, the level of support provided by UPM to Albion was to decrease from 3p/m³ to 1.5p/m³ in June 2004, and to expire in March 2005. In his letter to the Director of 10 December 2003 Mr Gale said:

> "I wish to state that I believe this level of support to be unprecedented in the water industry. UPM has been forced to accept that it is necessary as the only method of ensuring the continuation of an independent Albion Water, which is committed to support UPM's operations in the UK and is determined to fight to deliver the benefits of greater competition."

*The later stages of the Director's investigation*

70. On 22 October 2003 the Director indicated to Albion that a "draft" decision would be available in December 2003, with a "final" decision at the end of February 2004.

71. On 20 November 2003 the WA03 received the Royal Assent. Although the WA03 did not come into force during the period relevant to these proceedings, the provisions of that Act, and in particular the "Costs Principle" referred to in the new section 66E inserted into the WIA91, played an important part in the Director's reasoning in the Decision, as explained below.

72. On 29 December 2003 the Director indicated to Albion that the revised "draft" decision would be issued in mid-January 2004.

73. On 7 January 2004 the Director wrote to Dŵr Cymru requesting Dŵr Cymru to state the current access price to Albion for the treatment and transport of non-potable water for onward supply to Shotton Paper. Dŵr Cymru replied on 16 January 2004 to the effect that its access price to Albion would be 17.74p/m³ excluding "administrative and associated costs". This price is referred to in the Decision as the "Second Access Price" (see paragraph 249 of the Decision). The Second Access Price was apparently derived from the New Tariff for large non-potable users introduced by Dŵr Cymru in April 2003. The correspondence about the Second Access Price was not supplied to Albion until 17 March 2004.

74. Following a further complaint by Albion on 13 January 2004 about the delay in reaching a decision, the Director indicated by letter of 20 January 2004 that the "draft" decision would be available in March 2004. On 29 March 2004 the Director indicated to Albion that the promise of a draft decision in March 2004 could not be honoured.

*Proceedings before the Tribunal*

75. On 2 April 2004 Albion introduced an appeal before the Tribunal in Case 1031/2/4/04 ("Case 1031") under the then section 47 of the 1998 Act. The basis of that appeal was that the Director had, in fact, already made, or should be deemed to have made, one or more appealable decisions within the meaning of section 47 of the Act and that the various delays by the Director were simply "intended to deny Albion Water the right of appeal to the Tribunal" (Notice of application, paragraph 104). The extensive relief sought by Albion included a request that the Tribunal adopt interim measures to preserve Albion's existence pending the determination of the appeal.

76. On 7 April 2004 the Director sent Albion a further "draft" decision, at the same time inviting Albion to withdraw its appeal in Case 1031 on grounds of prematurity.

77. A case management conference in Case 1031 took place on 29 April 2004. At that case management conference the Director told the Tribunal that, notwithstanding that a substantial draft decision already existed, he still required a further eight weeks to finalise the document. Albion protested against that delay, and reiterated its application for interim measures, pointing out that the financial support it was receiving from Shotton Paper had been predicated on the adoption of a decision in November 2003, and would substantially diminish with effect from June 2004. According to Albion, on the envisaged timescale for the adoption of the Decision and the subsequent appeal, there was a substantial risk that Albion would go out of business before the matter could be decided. Albion's application for interim relief was, however, contested by the Director and Dŵr Cymru, notably on the basis that Case 1031 was itself inadmissible, it being submitted that the Director had taken no appealable decision.

78. In ruling on these matters on 29 April 2004, the Tribunal considered that the Director's envisaged timescale was too long. In addition, the Tribunal pointed out that by virtue

of The Competition Act 1998 and Other Enactments (Amendment) Regulations 2004, SI 2004/1261, the Tribunal would have, with effect from 1 May 2004, jurisdiction to hear a direct appeal by Albion against a refusal by the Director to grant interim measures: see [2004] CAT 9. The Tribunal adjourned the matter to the next case management conference fixed for 2 June 2004 to enable discussions to take place between the parties.

79. On 4 May 2004 Albion formally asked the Director to adopt interim measures in favour of Albion. That request was refused by the Director on 25 May 2004.

80. The Decision challenged in the present appeal was adopted on 26 May 2004.

81. On 28 May 2004 Albion appealed to the Tribunal in Case 1034/2/4/04 (IR) against the Director's refusal to adopt interim measures and made a further formal application to the Tribunal for the adoption of interim measures (Case 1034). At the case management conference on 2 June 2004, the Tribunal made an interim order, by consent, the effect of which was that Dŵr Cymru agreed to reduce its price for the supply of water to Albion by 2.05p/$m^3$, pending the disposal of the proceedings.

82. In a separate appeal lodged on 12 July 2004 in Case 1042/2/4/04 ("Case 1042"), Albion challenged another decision of the Director entitled "Thames Water Utilities Ltd/Bath House and Albion Yard" dated 31 March 2003, which the Director had declined to withdraw by a decision of 11 May 2004, apparently notified to Albion on 7 July 2004. The present appeal and the Bath House appeal (Case 1042) raise some common issues but have proceeded separately.

83. On 21 July 2004 an appeal against the Decision was submitted by Aquavitae (UK) Limited ("Aquavitae") in Case 1045/2/4/04 ("Case 1045"). Aquavitae is a company active in the water industry which wishes to trade as a licensed water retailer by negotiating contracts with large industrial users and obtaining supplies of water from the statutory water undertakers, taking advantage of the new provisions for the licensed retailing of water contained in the WA03.

84. On 23 July 2004 Albion lodged the present appeal, Case 1046/2/4/04, against the Decision.

85. At the case management conference on 21 September 2004 the Tribunal stayed Albion's appeal in Case 1031 pending the present appeal. Pursuant to a ruling made on 16 November 2004, the Tribunal ordered that Aquavitae's appeal in Case 1045 also be stayed, but that Aquavitae should be permitted to intervene in the present proceedings, such intervention being limited to certain issues: see [2004] CAT 19.

86. Following the case management conference on 21 September 2004, Dŵr Cymru and the Director gave extensive voluntary disclosure, latterly on 24 March 2005. On 3 February 2005 the Tribunal paid a site visit to the Ashgrove system. On 22 March 2005 the Tribunal sent the parties a list of questions. The present appeal was heard on 9, 10 and 11 May 2005. On 11 May 2005 the Tribunal made a further ruling [2005] CAT 19 in Cases 1034 and 1046 (the present case) to maintain the effect of the earlier interim measures consent order of 2 June 2004.

87. The hearing in the Bath House case (Case 1042) took place on 20 and 21 June 2005, following a site visit on 26 May 2005.

## IV THE STATUTORY FRAMEWORK

### *The 1998 Act*

88. Pursuant to section 54, and paragraph 5 of Schedule 10 of the 1998 Act, amending section 31(3) of the WIA91, the Director has concurrent powers with the OFT to apply the provisions of the 1998 Act, notably in relation to commercial activities connected with the supply of water or securing a supply of water. The Decision under appeal was taken under section 18 of the 1998 Act imposing the Chapter II prohibition:

> (1) [A]ny conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.
>
> (2) Conduct may, in particular, constitute such an abuse if it consists in -

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

(b) limiting production, markets or technical development to the prejudice of consumers;

(c) applying dissimilar conditions to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.

…"

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

*OFT 422*

90. The Director, together with the OFT, has issued guidance on the manner in which his powers under the 1998 Act will be exercised within the area of his competence: see *The Competition Act 1998: Application in the water and sewerage sectors* (OFT 422). This guidance has not been amended or withdrawn. Paragraphs 4.9 and 4.16 provide:

"***Approach to cost assessment***

4.9 Costs will be a key consideration in the assessment of pricing conduct in relation to the Act's prohibitions: their assessment will follow the approach outlined in the Competition Act guideline ***Assessment of Individual Agreements and Conduct.*** Where the Director has grounds to suspect that pricing conduct breaches either of the prohibitions in the Act, he will investigate the costs of providing the product or service in question. He will make use of cost information already available to him and will examine the consistency of approach used by undertakers in cost analyses for the purposes of setting tariffs and special agreements, arrangements for bulk supplies, resource development, leakage control and demand management.

…

***Excessive prices***

4.14 Where an undertaking is dominant in a market, it is possible that prices may be set at excessively high levels.

> Prices may be considered excessively high when the price charged bears no reasonable relation to the economic value of the good or service supplied. In this instance, such behaviour could be an abuse of a dominant market position under the Chapter II prohibition. In cases where there may be excessive pricing, the Director may have regard to measures of the profitability or the 'stand-alone costs' of an activity."

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

> "4.16 The Director regards 'common carriage' as the shared use of assets by undertakings. In many circumstances it would be uneconomic for a competitor to duplicate the provision of large assets, such as a pipe network or treatment facility. Common carriage, therefore, has the potential to increase customer choice by facilitating the entry of competitors (whether existing undertakers or new entrants) into a local market.
>
> 4.17 There is no specific statutory framework for common carriage, but this does not prevent undertakings from agreeing to such arrangements, including the associated terms and conditions. In general, however, incumbent undertakers may have little incentive to offer access to their facilities to other suppliers. In some cases refusal to allow a competitor to access or share facilities may be objectively justifiable – where, for example, the competitor refused to give adequate assurances on water quality or refused to make a reasonable contribution to necessary reinforcement costs. In other cases the refusal may be without any objective justification. Under the Act, such a refusal by a dominant undertaking to grant access to facilities that would allow another undertaking to compete in a related market may be an abuse of a dominant position. Similarly, the imposition of unreasonable price or non-price terms for access could infringe the Chapter II prohibition.
>
> 4.18 The Water Industry Act 1991 provides an effective legal framework for the development of common carriage in a manner that safeguards customers' interests. Undertakers' approaches to the development of common carriage should not endanger the ability of the Director or of undertakers to fulfil their respective statutory duties. In this regard there are a number of issues that undertakers

should address in any common carriage agreements. These include:

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

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

4.20 The Director will, therefore, use his powers under the Act to deal with abusive conduct by dominant undertakings. This will allow common carriage to develop where there are genuine opportunities for improved services to customers."

*Guidance letters*

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

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

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

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

94. In MD 163 the Director also states:

> "The Government's consultation paper on competition in the water industry[10] said that the properly managed development of effective competition is desirable. Common carriage is one route through which competition can develop further. It presents a challenge to existing companies, but it also creates opportunities for companies to develop and grow their businesses. Many companies have recognized this and I welcome their positive response…
>
> Each company should charge entrants as it would charge itself and should be able to demonstrate this, both to entrants and the regulator, if asked to do so."

95. In March 2002, the Director issued a guidance document "Access Codes for Common Carriage" ("the Access Code"). This Access Code has not been amended or withdrawn, but according to the Director "does not necessarily reflect the Director's most up to date thinking".

96. As far as we know, no common carriage arrangements have in fact come into existence[11], the present case and the Bath House case being the only ones in which the application of the 1998 Act to common carriage has been considered.

***The WIA91***

*General*

97. The following paragraphs describe the WIA91 as in force during these proceedings. The amendments introduced by the WA03 are referred to later in this judgment.

98. Under the WIA91, the Director, through the Office of Water Services (Ofwat), is responsible for the economic regulation of the water and sewerage industries in England and Wales. Environmental regulation is carried out by other agencies, such as the Environment Agency, whose responsibilities include the licensing of water

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

[11] The Tribunal is aware of two examples of bulk supply agreements between statutory water undertakers. The first is between Severn Trent and Wessex Water, where the former has an inset appointment in relation to Northern Foods in the area of the latter. The second, involving Kodak in North London, appears no longer to be extant (Annex 5 to Dŵr Cymru's intervention). Neither case appears to have involved common carriage. The small number of other inset appointments made by the Director to date (about 10) all appear to involve the use of the customers', or the water undertaker's own supplies. For example supply by Anglian Water to Buxted Chicken involved the laying of a new pipe (Paragraph 188 of the Decision).

abstraction and the control of river water quality, and the Drinking Water Inspectorate, which regulates drinking water quality. The Secretary of State is responsible for the conditions of appointment of water and sewerage companies as statutory undertakers. The Secretary of State, DEFRA, and the Minister for the Environment, Welsh Assembly Government, are responsible for the policy framework of the industry and have various reserve and other powers which are not relevant for present purposes.

*The Director's duties*

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

> "(2) The Secretary of State or, as the case may be, the Director shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner that he considers is best calculated –
>
> (a) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales; and
>
> (b) without prejudice to the generality of paragraph (a) above, to secure that companies holding appointments under Chapter I of Part II of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of the functions of such undertakers.
>
> (3) Subject to subsection (2) above, the Secretary of State or, as the case may be, the Director shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner that he considers is best calculated –
>
> (a) to ensure that the interests of every person who is a customer or potential customer of a company which has been or may be appointed under Chapter I of Part II of this Act to be a relevant undertaker are protected as respects the fixing and recovery by that company of water and drainage charges and, in particular—
>
> (i) that the interests of customers and potential customers in rural areas are so protected; and

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

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

…

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

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

100. However, by virtue of section 2(6A) of the WIA 91, inserted by Schedule 10, paragraph 4 of the 1998 Act, sub-sections (2) to (4) of section 2 of the WIA91 as in force at the material time do not apply in relation to anything done by the Director in the exercise of his functions under the 1998 Act, unless it is a matter to which the OFT could have regard when exercising those functions (section 2 (6B)).

*Appointment of statutory water undertakers*

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

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

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

*Inset appointments*

104. Under section 7 of the WIA91 as amended, the Director has the power to replace an existing statutory water undertaker with another statutory water undertaker as the water and/or water and sewerage undertaker by an "inset appointment" for a specified geographical area. Under section 7(5) of the WIA91, an inset appointment could be granted, notably, in the case of premises which are likely to be supplied with at least 100Ml of water per year (250Ml of water if on the territory of a water undertaker wholly or mainly in Wales), with the written consent of the customer responsible for those premises[12]. Albion's inset appointment in 1999 was apparently granted pursuant to this latter provision. In practice, only a few inset appointments have been granted, and only this case and possibly one other, involve bulk supplies of water[13].

105. According to the Director, when an inset appointment is made the appointee becomes the statutory water and/or sewerage undertaker for the specified area and has the same rights and obligations as other statutory undertakers under the WIA 91, as well as the environmental and water quality obligations regulated by the Environment Agency and the Drinking Water Inspectorate.

[12] The 100Ml limit was reduced to 50Ml for customers in England by the Water and Sewerage Undertakers (Inset Appointment) Regulations 2005 (SI 2005/268). The 250 megalitre limit for customers in Wales remained the same.
[13] See footnote 11 above.

*Bulk supply agreements*

106. A company which has been awarded an inset appointment by the Director is entitled, pursuant to section 40 WIA91 as amended, to receive a "supply of water in bulk" from an existing water undertaker. Section 40(1) WIA 91 provides as far as material:

> "(1) Where, on the application of any qualifying person –
>
> (a) it appears to the Director that it is necessary or expedient for the purposes of securing the efficient use of water resources, or the efficient supply of water, that the water undertaker specified in the application ("the supplier") should give a supply of water in bulk to the applicant; and
>
> (b) the Director is satisfied that the giving and taking of such a supply cannot be secured by agreement,
>
> the Director may by order require the supplier to give and the applicant to take such a supply for such period and on such terms and conditions as may be provided in the order."

107. Albion was, at the material time, a "qualifying person" for the purposes of section 40 WIA91. Section 40(6) provides:

> "(6) In exercising his functions under this section, the Director shall have regard to the desirability of –
>
> (a) facilitating effective competition within the water supply industry;
>
> (b) the supplier's recovering the expenses of complying with its obligations by virtue of this section and securing a reasonable return on its capital;
>
> (c) the supplier's being able to meet its existing obligations, and likely future obligations to supply water without having to incur unreasonable expenditure in carrying out works;
>
> (d) not putting at risk the ability of the supplier to meet its existing obligations or likely future obligations to supply water."

108. Section 40A of the WIA91 provides for the variation and termination of bulk supply agreements. Under section 40A(7) the Director must have regard to the same matters as are referred to in section 40(6) of the WIA91, including "(a) facilitating effective competition within the water supply industry".

*Price regulation*

109. The conditions of appointment of the statutory water undertakers include "Condition B", under which the Director regulates the prices which the undertaker is permitted to charge by setting a limit on the average increase that can be imposed in any year.

110. The Director carries out 5-yearly periodic reviews comparing the performance of each water company and setting prices on the basis of the most efficient. The limit set is referred to as the "K factor" and an undertaker can increase (or must decrease) its charges each year by the K factor above (or below) the rate of inflation. This system, as we understand it, is intended to promote lower charges through increased efficiency, thus acting as a kind of proxy for direct market competition between water companies. We understand this is sometimes referred to as "comparative competition". In the event of a dispute, the matter may be referred to the Competition Commission.

111. The K factor is applied to a tariff basket of regulated and unregulated charges for unmeasured water, sewerage and trade effluent services. Provided the overall average increase in charges within the basket is within the price limit (K factor + inflation), undertakers can alter individual charges to differing extents, subject to other regulatory constraints on price setting.

112. Charges for large customers (at the relevant time customers using more than 100 Megalitres per year for undertakers in England and more than 250 Megalitres per year for undertakers whose authorised areas are wholly or mainly in Wales) are excluded from the tariff basket. These large customers, which include Shotton Paper, are eligible to be served by an inset appointment. According to the Director in the defence, these customers are excluded from the tariff basket because their prices are determined, to a certain extent, by competition and do not require the same degree of regulation as other charges.

113. It appears that charges to large users were taken out of the tariff basket with effect from the charging year 2001/2002. In his "Tariff Structure and Charges" report for that year the then Director said:

> "Taking large users out of the tariff basket means that companies cannot automatically recoup from other customers

> lost revenue arising from reduced charges to their large users. These large users are part of a competitive market that does not require the same degree of regulation as other groups of customers.
>
> In response to competitive pressures, companies have continued to review their cost allocations between different classes of customers and develop tariffs for large user customers. Companies have either reduced the thresholds for larger user tariffs and/or reduced the volumetric rates for the tariffs concerned. In addition a few companies have introduced innovative tariffs for large users designed to align tariffs more closely to the costs of supply and to maintain incentives to efficient use.
>
> Notwithstanding this, companies must ensure that charges to large users are not unduly preferential or unduly discriminatory. They must also ensure that they are not acting anti-competitively."

114. Charges for non-household customers can be set either via an approved tariff scheme or by a special agreement. The Director may refuse to approve a tariff scheme if the proposed tariffs are incompatible with the undertaker's appointment conditions, or with his duties under section 2 of the WIA91.

115. Special agreements with non-household customers are authorised by section 142(2)(b) of the WIA91. A customer under a special agreement typically pays a non-standard charge to reflect its individual circumstances, a point we discuss further below. According to the Director, Appointment Condition E applies to any new special agreements, and such agreements must therefore not be unduly preferential or discriminatory.

116. As we have said, at the material time all Dŵr Cymru's large industrial non-potable customers were supplied under special agreements. Notwithstanding the introduction of the New Tariff for large industrial non-potable customers in 2003, very few customers were actually on that tariff at the time of the Decision.

117. Bulk supply agreements do not fall within the tariff basket and are not subject to Appointment Condition E. The price of water sold under a bulk supply agreement can however be determined by the Director under sections 40 and 40A of the WIA91, referred to above.

***The Water Act 2003***

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

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

*The Director's amended general duties*

120. The statutory duties imposed on the Director by section 2 of the WIA91 are amended by section 39 of the WA03. The new section 2 of the WIA91, as amended, replaces the previous version of section 2 set out above and came into force on 1 April 2005. The new section 2 includes the following provisions:

> "(2A) The Secretary of State or, as the case may be, the Authority[14] shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner which he or it considers is best calculated –
>
> (a) to further the consumer objective;
>
> (b) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;
>
> (c) to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and

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

(d) to secure that the activities authorised by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.

(2B) The consumer objective mentioned in subsection (2A)(a) above is to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services."

*The licensing provisions*

121. Prospective water suppliers are able to apply for one of two types of licence. The first, a retail authorisation, enables the licensed supplier to purchase water at the boundary of the distribution network owned by the statutory water undertaker and a customer's premises, on a wholesale basis, in order to provide that customer with water on a retail basis: section 17A(2). This is referred to as a "retail licence": section 17A(4). The second type of licence, a "combined licence", allows the licensee to input water into the statutory water undertaker's supply system and have its water conveyed through the distribution network owned by the statutory water undertaker, on a common carriage basis, in order to supply its end customer with water: see section 17A(5) and (6) of the WIA 91. The first type of licence has a structure similar to current arrangements between Albion and Dŵr Cymru, set out at Figure 1. The second type of licence reflects how Albion would like to be able to supply water to Shotton Paper, set out at Figure 2[15]. These provisions apply to customers with an annual demand of over 50Ml: section 17D(2).

*Supply duties and charging provisions*

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

[15] We have not considered in this judgment the effect of the coming into force of these provisions on either the existing or proposed arrangements set out in Figures 1 and 2, although the parties have submitted their views on this question.

123. These provisions:

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

124. Section 66D(1) and (2) provide that the terms and conditions on which supplies are made available by water undertakers to licensed water suppliers in accordance with Sections 66A to 66C are to be agreed or, in default, determined by the Director[16]. Section 66D provides:

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

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

126. Section 66D(9) provides that no direction may be issued under section 32 (directions as to agreements) or 35(2) (interim measures directions) of the 1998 Act by either the OFT or the Director in respect of an agreement made under section 66D of the WA03. However, the effect of section 66D(10) is that the OFT or the Director may issue

[16] From 1 April 2006, by the Authority which replaces the Director.

interim measures directions under section 35(1)(b) of the 1998 Act in respect of conduct connected with agreements reached under section 66D of the WA03 if they have a reasonable suspicion that the Chapter II prohibition has been infringed.

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

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

129. Section 66E of the WA03 sets out "the Costs Principle" which we do not discuss in this interim judgment.

## V DŴR CYMRU AND ITS CUSTOMERS

130. In 2002/2003 Dwr Cymru's revenue was some £457 million from its appointed business, of which £222 million was from water services and some £235 million was for sewerage services. Dwr Cymru tells us that it has some 1.2 million household customers, and some 110,000 non-household customers in Wales and some adjoining areas in England. Its total potable network of pipes is some 27,000 km, with associated works, pumping stations and reservoirs.

131. Dŵr Cymru tells us that it has improved its efficiency and has recently rebated some £18 to each customer off water bills. Many of Dŵr Cymru's activities are contracted out. For example, the Ashgrove treatment plant is managed on Dŵr Cymru's behalf by United Utilities. While we bear in mind this progress by Dŵr Cymru, these background matters do not seem to us strictly relevant to the issues before us. It has not been suggested that Dŵr Cymru is not an undertaking for the purposes of the Chapter II prohibition, notwithstanding its "not for profit" status.

132. This case is concerned with the supply of non-potable water to industrial customers of the largest kind. In broad terms, water treated by Dwr Cymru to potable standards appears to be of the order of around 325,000 Ml per annum, whereas non-potable water supplied is around 27,000 Ml per annum[17]. Non-potable water supplied is thus apparently around 8 per cent of total supplies. Almost all this volume is supplied to large users.

133. Dŵr Cymru emphasises that a large number of industrial customers "self supply" using their own boreholes. According to Dŵr Cymru, about 50 per cent of industrial users "self supply". Although there is some evidence in Lynette Cross' witness statement filed on behalf of Dŵr Cymru that attempts have been made to find boreholes on the Shotton Paper and Corus sites, we have no evidence that this has proved to be a feasible alternative proposition in this case (Decision, paragraph 205).

134. At the material time all non-potable water supplied by Dŵr Cymru was delivered at non-standard rates, i.e. not at non-tariff rates[18]. In 2002/2003 there appeared to be about 13 non-potable customers in total, apart from Albion, of whom 7 took more than 1,000 Ml per annum[19].

135. Dŵr Cymru's revenue from non-potable customers in 2002/2003 was stated to be £6.1 million, apparently about 3 per cent of total water services revenue of some £222 million. In 2002/2003 supplies of non-potable water to Albion were classified as "bulk supplies"; these yielded a further £1.8 million of revenue. Supplies of non-potable water, including supplies to Albion, therefore appear to have amounted to about £7.9 million, or some 3.6 per cent of total water services revenue.

136. In 2002/2003 Dwr Cymru's largest non-potable customers (including Albion) appear to have been as follows:

| | Ml |
|---|---|
| WSH NON POT 5 | 10,209 |

[17] Figures derived from 5/16 annexed to the notice of appeal, lines 33 and 26 and referred to by the Director at paragraph 107 of the defence. This figure apparently excludes the supplies to Albion. Surprisingly to the lay eye, the figures suggest that there is substantial leakage of around 25 per cent of potable water between the treatment works and the customer: ibid, line 24 compared with line 33.
[18] Ibid, line 27 compared with line 25.
[19] Ibid, 5/25.

| | |
|---|---|
| ALBION | 6,807 |
| WSH NON POT 9 | 5,527 |
| WSH NON POT 11 | 2,697 |
| WSH NON POT 12 | 2,427 |
| WSH NON POT 6 | 2,258 |
| WSH NON POT 13 | 2,702 |
| WSH NON POT 8 | 1,080 |

137. Shotton Paper appears, therefore, to be Dŵr Cymru's second largest industrial customer in Wales. Assuming a similar position in other water companies, this case appears to concern water supplies to one of the largest industrial non-potable customers in England and Wales.

138. Taking Shotton and Corus together, the Ashgrove system appears to account for between one quarter and one-third of the non-potable water supplied by Dŵr Cymru.

139. As regards potable users, the information supplied to the Director under cover of the letter of 2 December 1998 seems to indicate that Dwr Cymru had at that time 2 customers taking more than 1000 Ml of potable water per annum and just over 100 customers in the four tariff bands between 50Ml and 1000Ml per annum[20].

## VI THE DECISION

### *Albion's complaints*

140. The Director characterized Albion's complaints on pricing issues as follows at paragraphs 74 to 76 of the Decision:

"**Price related alleged breaches of the Chapter II Prohibition**

**Excessive Pricing**

74. Albion Water argued throughout its complaint that the First Access Price was excessive and that Dŵr Cymru was making supra-normal profits. The specific allegations Albion Water made about the First Access Price are set out below.
(a) Unreasonable cost recovery: Albion Water argued in a letter dated 25 January 2001 that the First Access Price was excessive because of the extent to which it

[20]Derived from D/35, Reply.

exceeded Albion Water's estimate of the direct costs of supply, based on Albion Water's belief that the relevant class of customer should comprise only Corus and Shotton.

(b) Criticisms of Dŵr Cymru's access price methodology: Albion Water criticised Dŵr Cymru's basic approach of calculating the First Access Price by using revenue figures as a proxy for costs, and working backwards from those figures to calculate the individual elements which went to make up the First Access Price. In a letter to us dated 8 March 2001, Enviro-Logic stated that, *"in the short run it is unreasonable to assume that current income is entirely representative of current network costs"*. Albion Water also challenged the detailed steps Dŵr Cymru had taken when calculating the First Access Price. These criticisms are discussed in more detail below…

**Price Squeezing**

75. In its letter to us dated 12 August 2003, Albion Water argued that, "*You are aware that Dŵr Cymru has not only allocated downstream costs (e.g. customer facing costs) to its upstream activities, it has also allocated costs of potable water transportation which are not relevant to the downstream market for the sale of non-potable water, neither to the upstream market. We find it difficult to imagine a clearer example of margin squeeze […]"*.

**Discrimination**

76. Albion Water also alleged that Dŵr Cymru had engaged in discriminatory conduct for the following reasons.

(a) Albion Water alleged that there were faults in Dŵr Cymru's calculation of the First Access Price. For example, in its letter to us dated 14 May 2002 Albion Water argued that *"[…] Dŵr Cymru insist on basing their charges on potable distribution costs rather than the costs of distributing non-potable water. We contend that the difference in costs between these two is considerable and that the use of potable costs for a non-potable delivery service is both discriminatory and anti-competitive"*.

(b) Albion Water said that Dŵr Cymru's approach to the First Access Price was inconsistent with an open letter from us to Managing Directors of all water undertakers dated 30 June 2000 ("MD 163") about "Pricing Issues for Common Carriage" in which we stated that a company should charge new entrants as it would charge itself.

(c) Albion Water argued that Dŵr Cymru had allegedly based the calculation of the First Access Price on an unrepresentative class of customer. However, in its letter to us dated 14 May 2002, Albion Water withdrew this particular part of its complaint.

(d) In a letter to us dated 5 July 2001, Albion Water argued that, *"the [First Access Price] proposed by Dŵr Cymru may potentially apply dissimilar conditions to equivalent transactions with other trading parties. It is significantly higher than prices offered during April and May 1997 by Dŵr Cymru's then sister company, [Hyder Industrial], for a similar supply to a proposed new customer in the vicinity"*.

141. Albion also made various complaints about "non price" abuses, which are summarised at paragraphs 77 to 83 of the Decision. These complaints are essentially to the effect that Dŵr Cymru unreasonably delayed in quoting an access price, failed to provide information or negotiate, sought to introduce new tariffs in order to attribute more costs to the access price, changed the price initially quoted, made various misrepresentations,

intentionally infringed the Chapter II prohibition, conducted its business inefficiently and limited markets to the detriment of consumers.

142. Of these various non-price complaints, the only one effectively pursued in the notice of appeal of 23 July 2004 is the issue of alleged delay on the part of Dŵr Cymru in quoting an access price, which is dealt with at paragraphs 373 to 378 of the Decision. We deal briefly with the issue of delay at the end of this judgment.

143. We observe that Albion first complained in March 2001. Two years later, by June 2003, the Director had confined himself only to the question whether the Ashgrove system was an "essential facility". The draft decision he issued in June 2003 did not, it appears, address the substance of Albion's complaint at all. In the circumstances of this case, we think that, with the benefit of hindsight, it would have been better if the Director had addressed the substance of the issues at a much earlier stage. A period of over three years in reaching the Decision seems to us to be considerable.

***Relevant market and dominance***

144. In the Decision, the Director devoted some 30 pages to considering the relevant product and geographical market, and whether Dŵr Cymru had a dominant position, before indicating (at paragraph 215) that, for the purposes of his analysis, the Director made the assumption that Dŵr Cymru does hold a dominant position on the relevant market within the meaning of the Chapter II prohibition.

145. Since that is the assumption upon which the Decision is predicated, we do not need to consider in detail the Director's analysis, at paragraphs 86 to 225 of the Decision, of the issue of dominance in the relevant market and the associated issue of whether the Ashgrove System is indeed an "essential facility" for the purposes of the Chapter II prohibition. We make it clear, however, that had we had to consider the issue of dominance, we would at first sight have had difficulty in agreeing with the Director's doubts as to whether Dŵr Cymru had a dominant position within the meaning of the Chapter II prohibition, and in particular his view that the suggested possibility of constructing a new pipeline to serve Shotton Paper instead of the Ashgrove System

would arguably negative any such dominant position. The Director was, in our view, correct to assume that Dŵr Cymru had a relevant dominant position.

146. We would also observe that the Decision (at paragraph 213) is somewhat equivocal as to what is the precise ambit of the relevant market in which Dŵr Cymru is assumed to be dominant. Like the Director in that paragraph, we accept as a starting point that Dŵr Cymru is to be assumed to be dominant in the market for the transportation of non-potable water for supply to industrial customers in the geographical area served by the Ashgrove system (Decision, paragraphs 104 to 110).

147. We also accept that, as Albion suggests in its skeleton argument, if Dŵr Cymru is assumed to be dominant in the (upstream) market for the *transportation* of non-potable water for supply to industrial customers in the geographical area served by the Ashgrove system, the principal issue in the case is whether Dŵr Cymru has abused that dominant position so as to eliminate or significantly impede competition in the (downstream) market for the supply of non-potable water to industrial customers in that area, that downstream market for the *supply* of non-potable water being a market within which Albion and Dŵr Cymru are actual or potential competitors. The distinction between the upstream supply of transportation services, on the one hand, and the downstream supply of the water itself, on the other hand, needs to be kept in mind.

***Excessive Pricing***

148. In the Decision, the Director states that he asked himself three questions:

> "(a) Did Dŵr Cymru misallocate any costs when calculating the First Access Price?
>
> (b) Does the First Access Price bear no reasonable relation to the economic value of the service provided, when judged by reference to the difference between the costs actually incurred by Dŵr Cymru and the price charged?
>
> (c) if the answer to (b) is in the affirmative, was the First Access Price unfair either in itself or when compared to competing services?"
>
> (paragraph 234)

*Dŵr Cymru's calculations*

149. In reply to those questions, the Director considered first the methodology by which Dŵr Cymru calculated the First Access Price of 23.2 p/m³, which was essentially based on an average accounting cost (AAC) method. As appears from paragraphs 250 to 307 of the Decision, Dŵr Cymru's calculation was in seven steps.

150. As we understand it, at Step 1 Dŵr Cymru started with the average price charged by it for supplying water to its entire customer base (including both potable and non-potable water but excluding water supplied under a major agreement known as the Elan Valley Supply Agreement, and the water supplied to Albion Water), which was 73.3p/m³. This figure is apparently based on Dŵr Cymru's total revenue in 1999/2000 (excluding "third party services")[21] divided by the total volume of water supplied, adjusted to 2000/2001 prices (paragraphs 258 to 260 of the Decision)[22]. Throughout the calculation Dŵr Cymru equated the revenues it had received with its "costs".

151. At Step 2, Dŵr Cymru then separated out the costs of "resources and treatment" from costs for distribution, to give a figure of 27.9p/m³ for resources and treatment and, by implication, a figure of 45.4p/m³ for distribution, although the latter figure is not shown in the diagrams in the Decision. At Step 3 Dŵr Cymru then separated resource costs from treatment costs, to give 3.9p/m³ for resources and 24p/m³ for treatment.

152. At Step 4, Dŵr Cymru did not use the distribution cost of 45.4p/m³ derived from Step 2, but turned to its large industrial tariff (LIT) for potable water, introduced in 1999/2000, in order to find a suitable proxy for bulk distribution costs. Dŵr Cymru's large industrial tariff identified a category of customers (in fact this category consisted of only two potable water customers) whose consumption of water was more than 1000 Ml per year. It was assumed that these customers were served via pipes with a 600 mm diameter (the largest size of pipes). The adjusted price for the supply of water to these large users, once various cost differences identified by Dŵr Cymru were taken into account, was calculated to be 43.9p/m³. Dŵr Cymru then subtracted from this figure

[21] We revert to "third party services" later in this judgment.
[22] Although the diagram at paragraph 251 of the Decision and the Table at paragraph 304 refer to Step 1 being the unit cost of "potable water", the text at paragraph 258 refers to the average unit price of both potable and non-potable water.

the costs of resources and treatment (27.9p/m³ according to the original calculations) to give a figure for bulk distribution of 16p/m³ for both potable and non-potable water.

153. At Step 5, Dŵr Cymru calculated the cost of treatment for non-potable, as distinct from potable, water. Dŵr Cymru assumed that the cost of treatment for non-potable water was 30% of the treatment cost for potable water: i.e. 7.2p/m³ (30% of 24p). At Step 6, Dŵr Cymru considered whether there was any difference between potable and non-potable water as regards the cost of bulk distribution. Dŵr Cymru considered that the cost of bulk distribution for non-potable water was the same as the cost of bulk distribution for potable water, so included the figure of 16 p/m³ identified above for bulk distribution costs.

154. At Step 7 the First Access Price of 23.2 p/m³ was thus arrived at by Dŵr Cymru as follows:

| | |
|---|---|
| Treatment cost | 7.2p/m³ |
| Bulk distribution cost | 16.0p/m³ |
| | 23.2p/m³ |

155. We note that on the basis of the 9p/m³ price for water quoted by United Utilities, the resulting total price to Albion would have been 32.2p/m³ - that is to say, a common carriage price of 23.2p/m³ plus a water resource cost of 9p/m³. Such a price of 32.2p/m³ would have been 6.2p/m³ more than Albion's prevailing retail price to Shotton Paper of 26p/m³. On the basis of the existing price of 3p/m³ for water paid by Dŵr Cymru to United Utilities, Albion could still have been required to pay 26.2 p/m³, (23.2p/m³ plus 3p/m³), just over Albion's existing price to Shotton Paper of 26 p/m³, and effectively the same as the price payable by Albion under the Second Bulk Supply Agreement. Whichever assumption is made about United Utilities' price, the First Access Price for common carriage left no margin for Albion, given that the de facto retail price being offered by Dŵr Cymru to Shotton Paper was 26p.

156. The First Access Price as quoted by Dŵr Cymru would thus effectively preclude any meaningful supply by Albion to Shotton Paper via the Ashgrove System using water supplied by United Utilities to Albion.

*The Director's approach in the Decision*

157. In assessing Dŵr Cymru's seven-step methodology, the Director made various adjustments in the Decision. Among those adjustments, the Director considered that Dŵr Cymru's figure of 27p/m³ for treatment costs at Step 2 should be adjusted to 21 p/m³, since certain costs which Dŵr Cymru had allocated to treatment should properly have been allocated to resources. It is implicit in this adjustment that the Director considered that the correct figure for water resources was not less than 6p/m³ (paragraph 279 of the Decision, discussing Step 3).

158. In addition, the Director made an important adjustment at Step 5, with regard to the cost of non-potable treatment. Referring at paragraph 294 of the Decision to the work done on Dŵr Cymru's New Tariff for large industrial non-potable users introduced in April 2003, which examined the treatment costs of 11 treatment works, the Director pointed out that, according to that work, the cost of treating non-potable water was only 15 per cent of the cost of treating potable water, not 30 per cent as assumed in Dŵr Cymru's calculations. On that basis, the Director considered that Dŵr Cymru's figure for the treatment cost for non-potable water should be reduced from 7.2p/$m^3$ to 3.2p/$m^3$.

159. The Director did not carry out a similar calculation in respect of the respective costs of the distribution of potable and non-potable water, since he accepted Dŵr Cymru's argument that these were broadly the same. At paragraphs 300 to 302 of the Decision the Director said:

> "300. The main cost drivers for transporting water through pipes are linked to the size (diameter) and the material and smoothness of the pipe, required flow rate, distance, direction and change in altitude between the points at which the water enters and leaves the pipe. These cost drivers are largely independent of the quality of the water being transported.
>
> 301. In practice, the differences in the physical characteristics (density and viscosity) of partially treated non-potable water and potable water would be minimal in so far as they could directly affect the costs of water distribution. It does not therefore appear that the cost of transporting a given volume of water is fundamentally affected by whether the water is potable or non-potable.

> 302. We do not therefore believe that Dŵr Cymru was unreasonable to assume that the cost of transporting non-potable water in bulk was the same as the cost of transporting potable water."

160. A considerable part of the argument in this case has concentrated on the sufficiency of those paragraphs of the Decision.

*The Director's conclusions on average accounting costs*

161. Reducing the treatment cost of non-potable water from 7.2p/$m^3$ to 3.2p/$m^3$, the Director concluded that the First Access Price should have been 19.2p/m³ rather than the 23.2p/m³ quoted by Dŵr Cymru. The Director's adjustments are summarised at paragraphs 303 to 307 of the Decision.

162. The Director also considered that the First Access Price appeared to be broadly consistent with the New Tariff for non-potable supplies to large industrial customers which Dŵr Cymru had introduced in April 2003 with the Director's approval (paragraphs 198 to 202 of the Decision). Moreover, according to the Director, Dŵr Cymru's approach was compatible with various Regulatory Accounting Guidelines ("RAGs") issued by the Director (paragraphs 308 to 316 of the Decision)[23].

163. Notwithstanding the reduction in the First Access Price from 23.2p/m³ to 19.2p/m³, at paragraphs 317 to 340 of the Decision the Director declined to require Dŵr Cymru to modify the First Access Price. The Director considered that if Dŵr Cymru had calculated an access price using what he considered to be the Efficient Component Pricing Rule (ECPR), then a price of 22.5p/m³ would have resulted. That latter price was sufficiently close to the First Access Price to show that the first Access Price was not an excessive price.

*ECPR, the Costs Principle and the Second Bulk Supply Agreement*

164. The Director considered that there were dangers in accepting only one approach when considering whether or not an access price was excessive (Decision, paragraph 318).

[23] Arguments earlier advanced by Albion about the correct interpretation of the RAGs have not been pursued.

Accordingly, the Decision states that the Director had regard to the price of the Second Bulk Supply Agreement, to the access price which in the Director's view the Costs Principle set out in section 66E of the WA03 would generate, and to the ECPR (paragraphs 318 and 319 of the Decision). According to the Director, both the Costs Principle and the ECPR are a "retail-minus" approach to pricing, the essential feature of which, in broad terms, is that the incumbent supplier is entitled to charge a new entrant the retail price which the incumbent would otherwise have received from the customer, less any costs that the incumbent avoids by not having to supply the customer in question. At paragraphs 320 to 322 of the Decision the Director apparently accepted the reasoning in reports on the ECPR prepared in 2000 and 2001 for Northumbrian Water by NERA, a private economics consultancy. However, it is conceded at paragraph 323 of the Decision:

> "Access prices calculated under an ECPR approach may be perceived as being more favourable to undertakers than prices derived from other approaches, including some alternative retail-minus approaches. This is because ECPR allows the undertaker to produce prices that fully compensate it for the net losses that it would incur when providing a common carriage or wholesale distribution service, as compared with continuing to supply the final customer itself."

165. The Director also considers, at paragraphs 324 to 327, that the Costs Principle under section 66E of the WIA 91 is a "retail minus" approach to pricing which reflects the ECPR.

166. The Director's reasoning is summarised at paragraphs 329 to 331 of the Decision as follows:

> "329. When considering any retail-minus approach, it is necessary to take the appropriate retail price, as a starting point. In this case, the appropriate retail price is that contained in the Second Bulk Supply Agreement at the time Albion Water made its complaint against Dŵr Cymru (i.e. 2000/2001), as Albion Water had effectively become Dŵr Cymru's customer in place of Shotton Paper itself. This price in 2000/2001 was 25.8p/$m^3$. Although we did not formally determine the price in the Second Bulk Supply Agreement, the parties agreed exactly the same price (26 p/$m^3$) we indicated that we would be minded to determine, if we were required to do so.

330. Under a "retail-minus" approach, the access price would be 25.8p/$m^3$ minus the avoidable costs of resources. These avoidable costs would be the specific costs attributable to the assets used to supply the customer (in this case, the water supplied by United Utilities Water from the Heronbridge Abstraction Point to Dŵr Cymru under the First Bulk Supply Agreement).

331. As noted in paragraph 65, historically Dŵr Cymru has paid approximately 3 p/$m^3$ for the relevant water under the First Bulk Supply Agreement. In 2000/2001, the price was 3.3 p/$m^3$. The access price resulting from an ECPR calculation would therefore have been approximately 22.5 p/$m^3$ (i.e. the retail price of 25.8 p/$m^3$ minus avoidable costs of approximately 3.3 p/$m^3$). We think that the Costs Principle would produce the same access price. The difference between this price and the First Access Price of 23.2 p/$m^3$ is very small: in percentage terms, it is only 3% of the First Access Price."

*The Director's overall conclusion*

167. Taking into account the price of 22.5 p/m³ derived from the retail-minus approach described above, the Director came to the conclusion that it was not shown that the First Access Price of 23.2p/m³ bore no reasonable relation to the economic value of the services supplied, notwithstanding that an average accounting cost approach would have given rise to a First Access Price of 19.2p/m³ (and, apparently, a Second Access Price of 17p/m³). The Director's conclusion rejecting Albion's case on excessive pricing is expressed in these terms at paragraphs 335 to 341 of the Decision:

"335. The second question we considered was whether the First Access Price could be said to bear no reasonable relation to the economic value of the service provided, when judged by reference to the difference between the costs actually incurred by Dŵr Cymru and the price charged.

336. There is no legal definition of the "economic value" of a service. In *United Brands*, the ECJ simply referred to examining differences between costs and prices. Similarly, there is no definition of "excessive" in the context of pricing.

337. We have considered how best to assess costs, and whether the First Access price is excessive in relation to those costs. On the one hand, Dŵr Cymru adopted a particular approach to calculating the First Access Price

which, with our adjustments to correct cost misallocation, would point to costs closer to 19.2 p/m³, than the 23.2 p/m³ of the First Access Price.

338. However, as discussed above, we think that there are dangers in accepting only one approach when assessing costs and whether or not an access price is excessive. We therefore had regard to the Second Bulk Supply Agreement, the Costs Principle, and ECPR. The access price resulting from an ECPR approach based on the Second Bulk Supply Agreement would be approximately 22.5 p/m³. We think that the Costs Principle would produce the same price.

339. In light of the above, and despite our dissatisfaction with the fact that the First Access Price did contain cost misallocation, we have doubts about whether the First Access Price could be said to bear no reasonable relation to the economic value of the service provided, when judged by reference to the difference between the costs actually incurred by Dŵr Cymru and the price charged.

340. In Napp the Tribunal stated that they found, "it difficult to imagine, for example, this Tribunal upholding a penalty if there were a reasonable doubt in our minds" and that, "It is for the Director to satisfy us in each case, on the basis of strong and compelling evidence, taking account of the seriousness of what is alleged, that the infringement is duly proved, the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be".

341. We are therefore unable to answer our second question in the affirmative, we do not therefore need to address our third question, and we conclude that Dŵr Cymru did not abuse a dominant position in breach of the Chapter II Prohibition by engaging in excessive pricing."

***Margin squeeze***

168. As to Albion's allegation of a margin squeeze, which is based essentially on the fact that the First Access Price payable to Dŵr Cymru for the (upstream) transportation of the water left Albion with no margin with which to compete in the (downstream) retail market for the supply of the water to Shotton Paper, the Director considered that, in this case, there had been no change in the retail activities carried on by Dŵr Cymru. The Director said:

"346. Prior to Albion Water's Inset Appointment, Dŵr Cymru had been supplying the relevant water to Shotton direct through the Ashgrove System. When Albion Water was granted its Inset Appointment, it simply purchased the water from Dŵr Cymru at the boundary of Shotton's premises (under the Second Bulk Supply Agreement), and sold it straight on to Shotton (under the Shotton Supply Agreement). It is difficult to see how, in practice, the nature of the "retail" activities carried out by Dŵr Cymru changed. It simply ceased supplying one customer (Shotton) and replaced this customer with a second customer (Albion Water).

347. Further, as discussed above, on 12 December 1996 we provisionally decided a price (26 p/$m^3$) as indicative of the price we would determine formally if we were asked to determine the Second Bulk Supply Agreement (although ultimately the parties agreed the same price without needing a formal determination). This price was based on other **retail** prices offered by Dŵr Cymru at the time (as well as Dŵr Cymru's estimated LRMC). The New Tariff, which is a retail tariff, is slightly below the price in the Second Bulk Supply Agreement. The price which Shotton agreed to pay Albion Water under the Shotton Bulk Supply Agreement is the same as that in the Second Bulk Supply Agreement. These are all consistent with Albion Water simply replacing Shotton as Dŵr Cymru's retail customer.

348. Importantly, we have seen no evidence that the arrival of Albion Water has resulted in Dŵr Cymru's ceasing to incur any retail costs."

169. Rejecting various arguments to the contrary advanced by Albion, the Director concluded at paragraphs 351 to 352:

"351. We do not have any evidence that Dŵr Cymru ceased to incur any retail costs as a result of supplying Albion Water under the Second Bulk Supply Agreement, or that Dŵr Cymru would make any similar saving under Albion Water's proposed new arrangement. In simple terms, Dŵr Cymru will continue to supply the same water, through the same pipes, to the same premises. It will continue to issue one set of bills to one customer. Assuming that the relevant "upstream" and "downstream" operations are treatment/transport operations and retail operations respectively, it is not necessary to analyse the split, and relationship, between these operations carried out by Dŵr Cymru, as Dŵr Cymru will continue to provide both.

> 352. In summary, we do not believe that Dŵr Cymru has abused a dominant position in breach of the Chapter II Prohibition in these circumstances, by engaging in price squeezing. In supplying Albion Water, Dŵr Cymru is in practical terms carrying on precisely the same water supply service and incurring the same costs as it was doing when it supplied Shotton directly."

***Price discrimination***

170. As regards price discrimination, at paragraphs 353 to 370 of the Decision, the Director considered that there was no evidence that Dŵr Cymru had or would charge other third parties, or its competitors, any differently from the way it proposed to charge Albion; that Albion, in a letter of 14 May 2002 had accepted that it was appropriate to use regional average, rather than local, costs; and that an alleged comparator, namely the alleged price quoted by Dŵr Cymru's then associate company Hyder Industrial for the supply of non-potable water to Helm Consulting in 1997 was not, in fact, comparable.

171. For all those reasons the Director rejected Albion's allegation of abuse in respect of Dŵr Cymru's pricing practices: paragraph 371 of the Decision.

## VII THE PARTIES' ARGUMENTS

### A. ALBION'S ARGUMENTS

172. Albion, represented initially by Dr Bryan in person and later by counsel, has refined its arguments in the course of the case, notably in the light of further disclosure by the Director and Dŵr Cymru.

***Excessive Pricing***

173. Albion submits that the First Access Price of 23.2p/m³ bears "no reasonable relation to the economic value of the product supplied" in accordance with the principles of EC and domestic competition law set out in decisions of the Court of Justice and elsewhere, in particular Case 27/76 *United Brands v. Commission* [1978] ECR 207, paragraphs 250 to 253 and the Tribunal's judgment in *Napp Pharmaceutical Holdings v. Commission* [2002] CAT 1. That is so, according to Albion, whether Dŵr Cymru's

price is scrutinised by reference to its costs, or relevant comparators. According to Albion, its argument is not undermined by the Director's use of the ECPR and/or the Costs Principle referred to in the Decision, which is also flawed in fact and law.

174. Albion considers that the Director has throughout considered only the interests of Dŵr Cymru, and has not considered the benefits of competition, or the interests of Shotton Paper or other industrial customers in achieving lower prices for non-potable water.

*The Director's average accounting cost calculations*

175. In relation to the Director's cost calculations, Albion submits that the average accounting costs calculations set out in paragraphs 250 to 307 of the Decision overstate Dŵr Cymru's costs, and were not adequately investigated by the Director. Although not explicitly accepting the Director's figure for treatments costs (3.2p/m³), Albion's criticisms are principally directed at the Director's figure of 16p/$m^3$ for distribution costs, which is the principal component of the common carriage price of 19.2 p/m³ arrived at by the Director's average accounting cost calculations.

176. In particular, Albion submits that an element of 16p/m³ for distribution costs, judged against what the Director considers in the Decision (Annex I, paragraph 27) to be operating costs of 1p/m³, and amounting to a charge of about £1 million a year for allowing non-potable water to flow by gravity through a 600mm pipeline for some 15 kilometres, is grossly excessive. The central error, according to Albion, is the Director's view, expressed at paragraphs 300 to 302 of the Decision, that the distribution costs for the bulk distribution of potable and non-potable water are the same.

177. In support of its case, Albion considers Dŵr Cymru's costs in a number of alternative methods which consist, essentially, of reconstructing Dŵr Cymru's costs from the "bottom up", or taking the local costs of the Ashgrove system, or making various comparisons of the likely costs of potable and non-potable mains distribution respectively.

178. In the first alternative method, Albion seeks to create a "profit and loss account" for the year 2002/2003 for Dŵr Cymru's "third party services". According to Albion, the RAGs issued by the Director require the cost of "services provided to third parties" to be shown separately in a water undertaker's regulatory accounts. Such services include "the cost of raw and treated water supplied to other companies, the cost of producing and delivering non-potable water…" (RAG 4, paragraph 3.2.7). Such costs, it appears, are to be excluded from the costs of the general water supply (RAG 4, paragraph 3.2.4). Similarly the Director requires revenues from "third party services" to be shown separately in what is known as the "June return". According to Albion, these various published figures allow an estimate to be made of the overall profitability to Dŵr Cymru of "third party services", and also to arrive at a reasonable cost estimate for the supply of the common carriage here in question. In the notice of appeal Albion calculated on the basis of the then available figures that a common carriage price would be of the order of 1.3p/m³.

179. Having refined its calculations in the reply in the light of the Director's comments, Albion considers that its calculations show that Dŵr Cymru's "third party services" were in 2002/2003 in general 4 to 6 times more profitable in terms of return on capital than the average return for the industry as a whole. At the stage of the reply, Albion submitted that, if the Director's figure of 16p/m³ for distribution costs were scaled back in line with industry average profit levels, the figure for the distribution costs of non-potable water would be between 2.6p/m³ and 3.8p/m³.

180. In its second method, Albion submits that the Ashgrove system should be treated as comparable in cost and efficiency to Dŵr Cymru's other surface water supply systems, typically comprising a reservoir and raw water aqueduct. The Ashgrove pipe, submits Albion, is equivalent to a raw water aqueduct, and is classified as such, according to Albion, by Dŵr Cymru (answers to section 26 notice of 29 June 2001; DC Asset Inventory dated 22 March 2005). The Ashgrove treatment plant, according to Albion, is of a very basic kind. The effect of passing the water through that system, whereby, in broad terms, the sludge goes to the bottom through a process of filtration and settlement, is equivalent in terms of cost and efficiency to a reservoir, according to Albion.

181. Basing itself on Dŵr Cymru's RAG and June return data included under the heading "Water Resources and Treatment", Albion calculates, on this method, taking into account certain points made by the Director in the defence, that the costs of distribution of non-potable water (including a return on capital) for 2002/2003 would be about 3.46p/m³, as against Dŵr Cymru's calculation of 16p/m³.[24] As we understand it, that is on the basis that the Ashgrove pipeline is properly treated as, or equivalent to, a raw water aqueduct.

182. In a third method, Albion seeks to calculate what price Dŵr Cymru would need to charge to recover its costs of the Ashgrove system. As regards treatment costs, Albion considers that a reasonable estimate of the cost of treatment, including a return on capital, would be some 2.01p/m³, as compared to the figure finally arrived at by the Director of 3.2p/m³.

183. As regards the key element of distribution costs, Albion notes that on the Director's own figure in Annex I to the Decision, the operating costs for distribution of non-potable water through the Ashgrove system are assumed by the Director to be 1.0p/m³. Albion considers the Director's proposition that the distribution costs for bulk non-potable water are the same as those for bulk potable water (16p/m³) to be unsustainable.

184. According to Albion at paragraph 179 of the notice of appeal, non-potable mains are of short length, and are found in rural areas where costs are low. Trunk potable mains, by contrast, are high pressure, and of higher integrity. They are often laid in urban areas under roads and their construction and maintenance costs are correspondingly high. It is inconceivable, says Albion that the costs of potable and non-potable mains distribution should be the same, as contended by the Director.

185. In the notice of appeal, Albion takes the published figure for Dŵr Cymru's total distribution costs, and estimates the proportion attributable to the potable trunk network. Albion then calculates the cost recovery per kilometre of that network, and applies the resulting figure to the 700 kilometres of non-potable mains and aqueducts

[24] Albion points out in its skeleton argument that this figure is based on 542 km of raw water aqueduct, which is the figure given by the Director in the defence, but that the disclosure given on 24 March 2005 suggests that the correct figure is that originally used by Albion in the notice of appeal of some 700 km, raw water aqueducts and non-potable mains being classified together by Dŵr Cymru in its asset inventory under the heading "Water Resources".

shown in Dŵr Cymru's cost inventories. If the distribution costs of potable and non potable water were really the same, says Albion, on this basis Dŵr Cymru would be recovering from the non-potable network more than 20 times what it recovers from the potable network. That, according to Albion, would be nonsensical.

186. Moreover, according to Albion, there is no, or no sufficient, evidence to support the "cost drivers" of transporting water through pipes mentioned by the Director at paragraph 300 of the Decision: potable bulk mains, according to Albion, have a higher value and higher renewal costs than non-potable supply systems. Regional average bulk potable throughput is substantially higher than bulk non-potable throughput, and the Ashgrove system itself operates by gravity with no pumping provided by Dŵr Cymru. In the notice of appeal, Albion submits that the distribution cost of non-potable water should not exceed 1.0p/m³.

187. Re-working its calculations in its reply on the basis of figures subsequently supplied by the Director of a total supply by Dŵr Cymru of non-potable water of 27000 Ml per annum, and non-potable mains of 158 kilometres[25], Albion reaches the conclusion that, if the Director's figures are right, Dŵr Cymru would be recovering approximately 5 times more in terms of £ per kilometre from the non-potable system than from the potable system, which in Albion's view is not credible. According to Albion, if the cost recovery of potable and non-potable mains systems were approximately equivalent, the distribution cost would be of the order of 3.25p/m³.

188. In a fourth method advanced at the stage of the reply, Albion considered further material disclosed by the Director relating to Dŵr Cymru's reply to the section 26 notice of 29 June 2001 in respect of Dŵr Cymru's analysis of the local costs of the Ashgrove system, prepared in 1995/96 in connection with the price to be charged under the Second Bulk Supply Agreement. On the basis of that analysis, and making allowance for what Albion considers to be inflated asset values, Albion considers that the local costs of the Ashgrove system, including return on capital, depreciation and

[25] According to Albion, this figure appears to be included in Dŵr Cymru's asset inventory of some 700km of raw water aqueducts.

renewals, would be of the order of 12.93p/m³. This suggests, according to Albion, a common carriage price of some 4.59p/m³[26].

189. Summarising these various bases, Albion's case in the reply would appear to be that a cost-reflective common carriage price would lie approximately in the range 4.5p/m³ to 7p/m³.

190. As regards the Director's objection that Albion's various approaches concentrate unduly on the local costs of the Ashgrove system without regard to the yardstick of regional average costs commonly used in the water industry, Albion has stated that it "accepts the use of average accounting costs" (Reply, p. 18 of Annex I). Albion submits, however, that water companies commonly "de-average" in having different tariffs for different classes of customer, which are commonly based on the reduced cost of supplying that class of customer. For example, Dŵr Cymru has different charges for bulk supplies, and for potable and non-potable water, the charges further varying within consumption bands and, for non-potable water, between "raw water" and "partially-treated water". In some cases there are only one or two customers in the class in question. Special agreements are also, according to Albion, an example of de-averaging. Moreover, Albion contends that the local costs for the Ashgrove system should in any event be approximately the same as the regional average costs, as Dŵr Cymru apparently contended in a letter to the Director of 27 February 1997 and in answer to the section 26 notice of 29 June 2001.

191. In a fifth method attached to its skeleton argument, Albion submitted a further analysis, based on the figures advanced by Dŵr Cymru as the justification for the introduction of its Large Industrial Tariff (LIT) for large potable users in a letter to the Director dated 2 December 1998. Making what it submits to be reasonable adjustments for non-potable supplies[27], Albion arrives at a figure for distribution costs (including depreciation and return on capital) of some 1.3p/m³. Albion alleges differences in relation, for example, to service reservoirs, pumping, waste detection, management, rates, customer service, scientific services, current cost depreciation, doubtful debts, and infrastructure

[26] 12.93p/m³ less estimated retail costs of 4.80p/m³ and 3.54p/m³ for the cost of water resources from United Utilities.
[27] The Director contends that Albion has in fact reduced the figures shown in Dŵr Cymru's document of 2 December 1998, before adjusting for what it says are differences for non-potable supplies.

renewals, and asset values (with corresponding implications for what is the appropriate return on capital).

192. In what we will describe as a sixth method, but which is in effect a variant of Albion's third method, advanced on the basis of the Director's disclosure of 24 March 2005, Albion argued at the hearing that the MEA (Modern Equivalent Asset) values shown in Dŵr Cymru's various documents for its potable and non-potable mains distribution systems are a good proxy for calculating the total cost difference between the two, as the Director accepted in relation to treatment costs at paragraph 279 of the Decision. According to Albion, Dŵr Cymru's inventory dated 22 March 2005 shows that the Ashgrove system is classified as a "raw water aqueduct", and is included in the 700km of such aqueducts having a total MEA value of £102 million (or about £145,000 per km). The same document shows a total of 27,000 km of potable mains, having a total MEA value of £3,964 million (or about £146,000 per km). The figures shown in Appendix 1 to Dŵr Cymru's justification for the Large Industrial Tariff in the letter dated 2 December 1998 are broadly comparable, in that they appear to show some 26,611 km of potable mains having a total MEA value of £3,847 million. However, the latter document gives a breakdown of the potable mains distribution system by different mains sizes. That breakdown shows 429 km of potable mains of 600mm diameter, having an MEA value of £696 million. That gives an MEA value per km of £1.6 million for 600 mm potable mains. Whereas, therefore, on Dŵr Cymru's classification the non-potable distribution system is valued at £145,000 per km, the 600mm potable mains system is valued at £1.6 million per km.

193. As set out above, Dŵr Cymru's approach, accepted by the Director, was to calculate non-potable treatment costs as a percentage of total costs based on the average difference in MEA values of the relevant treatment plants. If one were to adopt a similar approach to arrive at distribution costs for non-potable supplies, one would, according to Albion, arrive at the conclusion that such costs were approximately 9 per cent of the distribution costs of 600mm potable mains. According to Albion, this and a number of further calculations (e.g. including pipes of over 300mm, using Dŵr Cymru's own estimate of the MEA value of the Ashgrove system, or using the Director's own estimate in the Decision of the NPV of the Ashgrove system) all lead to the conclusion that the potable mains network has a significantly higher value than the

non-potable network. Similarly, potable bulk mains, according to Albion, have on Dŵr Cymru's figures higher infrastructure renewal costs than non-potable supply systems. Moreover, regional average bulk potable throughput is substantially higher on the Director's figures than bulk non-potable throughput.

194. On the basis of all these considerations, Albion submits that the Director is incorrect in concluding, or at least has not properly investigated, whether the costs of distribution by non-potable mains are the same as distribution by potable mains.

*ECPR, The Costs Principle and the Second Bulk Supply Agreement*

195. As regards the Director's alternative analysis based on the ECPR, or a "retail minus" approach, as set out at paragraphs 317 to 333 of the Decision, Albion's principal case is that this approach simply assumes what it seeks to prove, namely that the underlying price is reasonable.

196. In that regard, Albion criticises first the Director's starting point at paragraph 329 of the Decision, namely the price set out under the Second Bulk Supply Agreement of 26p/m³. Albion submits that it could not challenge the original price under the Second Bulk Supply Agreement at the time because it did not have the resources to apply for a judicial review. It contends that the calculations disclosed by Dŵr Cymru in answer to the section 26 request of 29 June 2001 now show that the price under the Second Bulk Supply Agreement was excessive. In addition, on the Director's own calculations in the Decision, the price under the Second Bulk Supply Agreement would in any event need to be reduced by 4p/m³ to take account of the Director's calculation of non-potable treatment costs. Account would also need to be taken of Albion's various calculations of distribution costs set out above, which on any view would further reduce the price significantly.

197. With regard to the Director's reasons for fixing the price under the Second Bulk Supply Agreement as he did, as set out at paragraph 40 of the Decision, Albion considers that the Director had only selective regard to the prices paid by other non-potable users,

ignoring four large non-potable users with lower prices ("the neglected four"), even though the latter, according to Albion, represent some 60 per cent of non-potable supplies. The Director also wrongly ignored the Elan Valley supplies.

198. As to the comparison apparently made by the Director with a supply to Hyder Industrial (then an associate company of Dŵr Cymru), Albion points to evidence that Hyder was in 1997 quoting prices in the range of 15p/m³ to 22p/m³, against the 28p/m³ mentioned in the Decision. According to Albion, no agreements with Hyder Industrial have appeared on the Director's published register of special agreements.

199. As to Dŵr Cymru's LRMC, referred to at paragraph 40 of the Decision as "approximately 26p/m³", Albion points to a leakage report published by the Director in 1991 which suggests that incremental operating costs for resources lay in the range 2.4p/m³ to 6.4p/m³, with no incremental capital costs being envisaged. Finally Albion points out that, at the time, the average non-potable retail price was, according to Albion, some 18.64p/m³. Since, according to Albion, the Director himself considers that retail costs are some 4p/m³, a retail tariff price of 18.64p/m³ would imply a bulk supply price of 14.64p/m³.

200. Albion further relies on the fact that Corus, Shotton Paper's neighbour, also supplied by the Ashgrove system, appears to enjoy a lower price. Albion points out that the Director specifically demanded a justification for the lower price to Corus in a letter dated 28 February 2000, but no such justification by Dŵr Cymru has been disclosed. In relation to the Corus lagoons, whose flow balancing functions according to the Director justify a lower price, Albion submits that Shotton too had made a capital contribution to the Ashgrove system, and has provided storage on site broadly equivalent, in Albion's view, to the balancing capacity of the Corus lagoons. Albion does not, however, contest the proposition that the Corus lagoons are in fact used for flow balancing purposes.

201. Similarly, Albion argues that the New Tariff for large industrial users of non-potable water introduced in April 2003 suffers from the same defect, in being based on distribution costs which are manifestly too high.

202. Finally, according to Albion, the Director has in any event misconstrued the effect of section 66E of the WIA 91 and the Costs Principle. That section, properly construed, neither mandates a retail minus approach, nor results in the ECPR price (22.3p/$m^3$) at which the Director purports to arrive. In particular, Albion criticises the Director's approach in the Decision whereby throughout his approach is purportedly based on regional average calculations, whereas when it comes to ECPR, the Director uses the local costs at Ashgrove to arrive at the "minus" in his "retail-minus" ECPR calculation. Aquavitae too advances detailed arguments on the construction of section 66E, and the Director's approach which, says Aquavitae, will prevent retail competition ever emerging, contrary to the intention of Parliament.

***Margin Squeeze***

203. As far as the issue of margin squeeze is concerned, Albion relies on the fact that on any realistic view the First Access Price would prevent Albion earning any margin at all on any supply of water it purchased from United Utilities for resale to Shotton Paper, just as it has been unable to earn any margin on the resale to Shotton (at 26p/$m^3$) of the water it currently purchases from Dŵr Cymru (at 26p/$m^3$) under the Second Bulk Supply Agreement. In Albion's submission, Dŵr Cymru has failed to charge Albion as it would charge itself, contrary to the guidance in MD 163.

204. Relying on *Genzyme v. OFT* [2004] CAT 5 and the EC jurisprudence there cited, Albion submits that the Director erred in law at paragraphs 345 to 352 of the Decision in failing to determine the margin required by a reasonably efficient supplier of water to Shotton Paper operating in competition with Dŵr Cymru, and instead wrongly considered only the level of savings occurring to Dŵr Cymru as a result of Albion's activities. Albion rejects the Director's argument that Albion does nothing which would entitle it to any margin, relying on its role as a broker, a statutory undertaker, a retailer, and a supplier of water management services as set out in Mr Jeffery's statement of 9 November 2004. According to Albion, these latter services equate to those notified to the Director by Dŵr Cymru by letter of 2 December 1998 when justifying its new Large Industrial Tariff for customers using more than 50 Ml per annum. The services supplied by Albion are said to include water management, the provision of detailed water data, and advice on water use efficiency and give rise to

direct operating costs, before any contribution to central overheads or profit, of some £120,000 p.a. That is equivalent to 1.77p/m³ (based on a supply of 6,800 Ml/yr). A reasonable contribution to overheads, according to Mr Jeffery, would equate to some 1.70p/$m^3$, giving total costs of 3.47 p/$m^3$. On the basis of a profit before tax of 1.53p/$m^3$, that would imply a retail margin of 5p/$m^3$, according to Mr Jeffery.

***Price discrimination***

205. As far as price discrimination is concerned, Albion maintains that it has been charged a higher price than other comparable customers without objective justification. Albion relies on: (i) the price at which Corus is supplied; (ii) prices paid by other large, especially non-potable, customers of Dŵr Cymru; (iii) the price payable under the Elan Valley Bulk Supply Agreement; and (iv) the prices payable under five bulk supply agreements on the Director's public register which show that the bulk supply price charged to Albion is by far the highest.

B. THE DIRECTOR'S ARGUMENTS

206. The Director maintains, essentially: (i) that the First Access Price was carefully and correctly assessed by reference to average cost calculations, the ECPR and the Cost Principle, and relevant comparators, none of which demonstrated that the First Access Price was excessive; (ii) that Albion performs no relevant function that would entitle Albion to require Dŵr Cymru to accord it a margin; and (iii) that there is no relevant price discrimination since such price differences as there may be arise either from non-comparable situations or are fully justified.

***Excessive Prices***

*The Director's general approach*

207. The Director accepts, in principle, the legitimacy of the average accounting method adopted by Dŵr Cymru. In particular, in the Director's view, Dŵr Cymru was correct to use "regional average" costs, an approach accepted by Albion in letters of 14 May 2002 and 12 August 2003. The Director submits that it is not now open to Albion to re-argue this issue before the Tribunal.

208. As regards the principle of regional averaging, the Director emphasises that there is no specific "distance-related" charging for water, and that there are many common costs in the water industry which are not straightforward to allocate to particular customers. Undertakers recover the total amount of revenue they are entitled to recover under price determinations through charges which are based on the average costs of supplying all customers in each undertaker's water supply area. According to the Director, "de-averaging" would result in price rises for some customers, particularly those in rural locations, which would be socially undesirable and have an adverse financial impact on some businesses. Prices would become more volatile, and some customers would face higher costs. There would be practical difficulties in collecting information on sub-regional costs, and allocating costs between end-users. Regulation by the Director would become more difficult, since regional average costs are transparent and understood in the context of the Director's annual reviews. A move to regionally de-averaged costs for discrete water zones such as Ashgrove would enable entrants to "cherry pick" zones with lower than average costs, leaving undertakers with the more expensive customers who would then face higher charges. According to the Director, regional average charging is mandated by the Director's duties under section 2 of the WIA91, and the Government's guidance on key water charging objectives issued under section 143(7) of the WIA91.

209. According to the Director, regional averaging needs to be carried out on a "top down" approach to costs – i.e. starting with average costs generally and then identifying the reduced costs of supplying particular classes of customer. This top-down approach has been used consistently in the water industry, as the Director has sought in the past ten years to require the industry to develop more cost reflective charges, as seen from the various large user tariffs that have been introduced since 1995. Albion's "bottom up" methodologies are inconsistent with this approach, and would disrupt the industry's approach to tariff setting and pricing generally.

210. According to the Director, it is also reasonable to use average revenues as a proxy for regional average costs as a starting point for his methodology, as long as there is no evidence that prices overall are excessive. While the Director accepts that that assumption does not of itself mean "that a company is not grossly over- or under-charging particular customers", the Director believes that his reviews of undertakers'

charging schemes, and Condition E of the instruments of appointment are adequate safeguards.

211. The Director's "top down" approach is based on audited data, whereas local "bottom up" data is often unavailable and could not easily be checked. A "top down" approach ensures the better allocation of joint costs (such as those of regulated rivers like the River Dee, or operational functions such as pipeline maintenance and telemetry), ensures that such costs are not omitted, and also ensures that universal service or social obligations (such as water for fire fighting, delivery of water in rural areas, or the protection of vulnerable customers) are properly reflected in charges. In "bottom up" calculations difficult judgments have to be made about the allocation of joint and common costs.

212. However, the Director accepts "de-averaging" as between classes of customer, so that tariffs or charges reflect, so far as possible, the costs of supplying a particular class: e.g. household and non-household, industrial, large users and smaller users, bulk supplies, potable and non-potable etc. Similarly, the Director accepts different prices in special agreements depending on the particular circumstances of the customer, but not solely on the basis of the geographical location of the customer (RD 09/03, 25 March 2003). It is *geographical* regional average charging which the Director seeks to maintain. It is not the Government's intention, says the Director, to enforce the unwinding of long standing cross-subsidies (Consultation Paper, paragraph 187).

213. In the Director's view, once it is accepted that a top down regional average approach to pricing is reasonable, all Albion's attempts to invoke the local costs of the Ashgrove system are of no relevance. Indeed, according to the Director, Albion now accepts this approach. Albion's fourth method is thus irrelevant.

214. Furthermore, the Director emphasises that the water industry is relatively capital intensive and characterised by large capital and "sunk" costs. In general, as regards both the water industry generally, and Dŵr Cymru in particular, the cost of maintaining and renewing the capital stock represents a high proportion of total revenue. Operating costs, on which Albion places heavy reliance, typically account for only some 20 per cent of total costs. Moreover, returns on capital calculated on the basis of specific

physical assets, as Albion purports to do, are of little relevance in an industry where the return on capital is calculated for regulatory purposes on the flotation value of the companies in 1989, plus net investment by providers of finance since that date, rather than on the notional replacement cost of the company's assets. Thus in 1989 Dŵr Cymru's regulatory asset value ("RAV") was £0.4 billion, whereas the notional replacement cost of its assets was £8 billion.

215. Generally speaking, according to the Director, in the water industry measured household customers pay from 40p/m³ to 100p/m³ for potable water supplies, whereas large potable users are charged 30p/m³ to 90p/m³. Large non-potable users (such as Shotton Paper) pay from approximately 15p/m³ to over 30p/m³ but the average pay between 20p/m³ to 30p/m³. Against that background, Albion's various figures are totally unrealistic. It is also unrealistic for Albion to expect to receive some 5p/m³ for "retail costs" while suggesting, in several of its calculations, that Dŵr Cymru should transport the water for less than that.

216. As regards the statement in MD 163 to the effect that a water undertaker should charge entrants as it would charge itself, the Director submits that, because undertakers do not have separate wholesale and retail businesses (in turn, according to the Director, because of difficulties in allocating common costs), MD 163 means that "undertakers should not set access prices for their competitors that are inconsistent with their final retail tariffs, without objective justification".

*Albion's methods of calculation*

217. Turning to Albion's different methods, the Director contends that Albion's first method is based on the attempt to create a profit and loss account for third party services. This is flawed, because the definition of "third party services" in RAG 4 is different from the definition in the June Return. Moreover, Albion's attempts to quantify the "missing" third party revenues are flawed, because Albion makes incorrect assumptions about what is included in "third party services" and what is not. This is because third party services are a residual cost category to remove costs which are not related to the general supply of potable water to customers. For example, no joint or common costs (such as

rates, doubtful debts) are allocated to third party services, as they would have to be in order to create a credible profit and loss account.

218. As regards Albion's second method, the Director says that this could be appropriate only for calculating the transport of raw water (e.g. from Heronbridge to the Ashgrove treatment works), not for the cost of transporting partially treated water. Nor do Albion's calculations allow for any return on capital, nor for overheads, rates, doubtful debts, exceptional items, or capital maintenance.

219. As regards Albion's third method, this relates only to operating costs and fails to allow for any common costs, overheads or capital costs. As regards distribution costs, the calculations should be based on some 27,000Ml of non-potable water supplied per annum. The use by Albion of an incorrect figure in the notice of appeal invalidates this methodology.

220. As regards more particularly the distribution costs of potable and non-potable water, the Director points out that the water leaving the Ashgrove treatment plant is not "raw" water but partially treated water. Under RAG 4 the costs associated with the transport of partially treated water properly fall within the category "third party services", not "water resources" as submitted by Albion.

221. Moreover, the Director maintains that the Ashgrove system is a distribution system for the transport of non-potable water, rather than a "raw water aqueduct" for the conveyance of raw water, as Albion alleges. According to the Director, the Ashgrove treatment works treats water to a higher quality than the water abstracted from a reservoir, in particular by removing smaller solids, whereas a reservoir only removes the largest particles.

222. According to the Director, in 2000 only 158 kilometres of the 700 kilometres of pipeline identified in Dŵr Cymru's asset inventory of raw water aqueducts were used to transport non-potable water, whereas the remaining 542 kilometres related to the raw aqueduct system. The average length of raw water aqueduct as calculated by the Director is 2.5 kilometres, very different from the length of the Ashgrove pipeline. The Director does not accept that average lengths should be calculated by dividing 542km

by the number of treatment works (44), but maintains that the correct calculation is to divide 542km by the number of sources – i.e. including boreholes (209) – which gives an average raw water aqueduct length of 2.5km  These figures invalidate Albion's attempts to compare the cost or value per kilometre of potable versus non-potable distribution mains.

223. The Director contends, in the rejoinder, that Albion's assumptions as to the characteristics of non-potable mains are mere assertions. For example, non-potable mains may be of high pressure depending on customers' requirements, non-potable mains serve large industrial customers which are often situated in urban areas. Equally, potable mains are situated in rural areas, as that is where many customers are located. It is also not the case that potable mains are laid under roads – they are instead often run alongside roads.

224. According to the Director, (rejoinder, page 50) the regional length of the bulk non-potable distribution system is 158km, compared with 440km for the regional length of the bulk potable distribution system. Some 27,000Ml is pumped through the former and, according to Albion, some 326,274Ml through the latter. On the basis of Albion's figure for Dŵr Cymru's distribution costs of £136.55million in 2002/2003, a recovery of 16p/m³ would enable Dŵr Cymru to recover some £52.5million (326Ml x 16p/m³) from the potable network and some £4.3million from the non-potable network, which says the Director, is not unreasonable.

225. At page 73 of the rejoinder the Director contends, however, that the correct length to use for the potable mains distribution network is 1834 kilometres, which takes into account both 300mm and 600mm pipes. According to the Director, that is the correct comparison because the non-potable system also uses some 300mm pipes. On that basis, the cost recovery per kilometre is some £28,464 per kilometre for the potable system (326,274Ml x 16p/m³ ÷ 1834 km). On the basis of the length of non-potable mains of 158 kilometres and non-potable water volume of 27,000Ml, the cost recovery per kilometre from the non-potable system is some £27,342 per km (27,000Ml x 16p/m³ ÷ 158km) which, again, is approximately the same.

226. As regards Albion's fourth method, based on Dŵr Cymru's breakdown of local costs of the Ashgrove system in 1995/1996, the Director says primarily that local costs are irrelevant. In the rejoinder (p.76) the Director says, however, that all but 15 per cent of the costs referred to "depend upon regional and generic assumptions". It was not unreasonable for the Director to ignore that analysis for the purposes of the Decision, because "it did not provide significant and differentiated information" and was somewhat dated. A proper analysis of local costs would have had to be forward-looking, taking into account the appropriate contribution to be made to regional common and joint costs.

227. Apart from various other criticisms of Albion's figures, the Director contends that the 6.2p allowed in Dŵr Cymru's 1995/96 calculations for "management on-costs" was to cover not just "retail" costs, but related to all the common and joint costs which Dŵr Cymru has to bear. Some joint costs such as local river regulation, the cost of storage at the Corus lagoons, and the costs of telemetry are not picked up in Albion's analysis.

228. As regards Albion's fifth method, which is based on the figures provided by Dŵr Cymru to the Director on 2 December 1998 to justify its new LIT for large potable users, the Director does not accept Albion's starting figures, and puts in issue the factual assumptions which Albion makes, namely that non-potable mains are typically not pumped, do not need flow balancing, require minimal leakage management, and are inherently shorter than their potable equivalents. Similarly Albion wrongly assumes that non-potable supplies cause fewer costs in respect of such matters as bad debt risks, scientific services and customer and regulatory services. The Director also queries why Albion did not use Dŵr Cymru's own MEA value for Ashgrove supplied to the Director, and why rates are allocated on the basis of MEA values rather than volume.

229. With regard to Albion's sixth method, advanced at the hearing, the Director, says essentially; (i) that it is not valid to compare the average cost of raw water aqueducts in the Dŵr Cymru inventory with the costs of bulk potable mains, because Ashgrove is not equivalent to a raw water aqueduct; and (ii) in any event, if correct figures are taken for the relevant lengths, the distribution cost recovery based on MEA values is approximately the same for potable and non-potable systems.

*ECPR, the Costs Principle and the Second Bulk Supply Agreement*

230. As to whether the retail price is an inappropriate starting point for a "retail-minus" approach, the Director sees nothing unreasonable or unfair in using existing retail prices, based on regional average pricing, as a starting point, given the extent to which retail prices are already regulated. Attempts to use some other starting point based on local costs would involve de-averaging, which would have wide ramifications. As a result of the price review process, retail prices already reflect current and predicted levels of efficiency, according to the Director.

231. As regards more particularly the Director's use of the Second Bulk Supply Agreement price of 26p/m³ as his starting point, the Director argues that this price was reasonably based on Dŵr Cymru's charges at the time to Hyder Industrial, on Dŵr Cymru's charges to other non-potable users, and on Dŵr Cymru's LRMC.

232. As to Albion's complaint as to the selective use of comparators, the Director contends that two out of the so called "neglected four" had made capital contributions to the system in question, while Corus had made available to Dŵr Cymru the balancing capacity of its lagoons. The fourth "neglected" customer had much smaller volumes than Shotton Paper. The Elan Valley Bulk Supply Agreement is not comparable for the reasons given in paragraphs 264 to 265 of the Decision. With regard to Hyder, the Director says that the special agreements register shows three non-potable agreements relating to Hyder Industrial in 1996/1997. According to the Director, the Hyder Industrial agreements in question were published in the register from 1998 onwards.

233. In any event, says the Director, the price under the Second Bulk Supply Agreement is comparable to the price that Shotton Paper would be paying if it was on the New Tariff introduced in 2003, which itself is cost based.

234. As regards LRMC, the Director considers that Albion has misunderstood his comments in his leakage report of May 1996. Dŵr Cymru's estimate of LRMC (apparently 48p/m³ in 2003/2004) is broadly in line with industry averages, according to the Director.

235. As regards the ECPR, the Director considers that it is correct to subtract from the retail price the resource cost saved by Dŵr Cymru, but in this respect to use local, not average costs, otherwise inefficient entry would be encouraged. Under ECPR, the access charge would vary according to the local cost of the resource saved. It is true that on this approach Albion would have no margin, but according to the Director, that is because Albion's business model is one that does not, or should not, generate any margin, because Albion does not do anything over and above what Dŵr Cymru has continued to do, as explained below in answer to Albion's submissions on margin squeeze. According to the Director, the circumstances in which a margin could be generated are primarily those where Albion could develop a new water source (Bath House was mentioned as a possible example) or provide some other "added value" such as consulting services.

236. Finally the Director considers that he has correctly construed section 66E of the WIA91. There are no avoidable costs, other than the water resource. In any event, Albion's calculations of the retail costs incurred by Dŵr Cymru in relation to customer service (4.8 p/m³) greatly over estimate Dŵr Cymru's cost in that regard, which should be calculated on a per customer, not volumetric, basis.

***Margin Squeeze***

237. The Director's case is that, as things stand, Dŵr Cymru has simply ceased supplying one customer (Shotton Paper) and replaced this customer with another customer (Albion) while continuing to supply all the services it previously supplied and incurring all the same costs. The situation is not materially different as regards the proposed arrangement whereby Albion would purchase the water from United Utilities and resell to Shotton Paper: the same water would be travelling through the Ashgrove system to the same customer, as before.

238. In addition, under the proposed common carriage agreement, Dŵr Cymru could not, according to the Director, save any costs other than the water resource costs. Dŵr Cymru could be carrying out the same customer relations function in relation to Shotton Paper, and the same water would be supplied through the same pipes to the same premises. Moreover, Albion does not provide any distinct service on a downstream

"retail market" and appears to confine itself to supply "consultancy–style services". In these circumstances the conditions for establishing a price squeeze under Community or domestic competition law are not met.

239. Although Albion has, by virtue of its inset appointment, assumed certain statutory functions, Dŵr Cymru will still be carrying out most of its previous functions. According to the Director, the water efficiency and management functions relied on by Dŵr Cymru when the LIT was introduced in 1999 are not customer specific, but relate to advice on websites and leaflets. Dŵr Cymru contemplates supplying onsite water efficiency services only in water-stretched zones. Albion's water management and data services are value added services which the customer would typically pay for separately. It is also reasonable for Dŵr Cymru to continue to use a customer relations manager. Dŵr Cymru still has to undertake billing and meter reading.

***Price Discrimination***

240. According to the Director, the prices allegedly quoted by Hyder Industrial in 1997 are not comparable, since, for example, they did not cover the cost of treatment or filtration. Enviro-Logic's refusal in 1997 to give permission prevented the Director from investigating that matter further. There is no sustainable evidence of price discrimination before the Tribunal.

241. According to the Director, of the various comparators referred to in Albion's skeleton argument, four of the five agreements in question are pre-privatisation agreements. One is the Elan Valley Supply Agreement, which is a special case, and another is the First Bulk Supply Agreement. Of nine other bulk supply agreements for which the Director has prices, six have prices of 19p/m³ or above. Under Severn Trent's inset agreement with Wessex Water to serve a Northern Foods site, Severn Trent pays Wessex Water according to the latter's large user tariffs. Dŵr Cymru's lower price to Corus is justified by the use of the Corus lagoons.

## VIII THE TRIBUNAL'S ANALYSIS

### A. THE TRIBUNAL'S POWERS AND DUTIES

242. Pursuant to Paragraph 3 (1) of Schedule 8 to the 1998 Act, the Tribunal is required to decide this case "on the merits" by reference to the grounds set out in the notice of appeal. Despite Albion having been accorded a certain latitude to develop its case in the light of the disclosure which has emerged in the course of the proceedings, it has not been suggested that Albion's submissions lie outside the four corners of the notice of appeal.

243. In *Freeserve v Director General of Telecommunications* [2003] CAT 5, since confirmed in *JJ Burgess & Sons v OFT* [2005] CAT 25, the Tribunal said there was in principle no difference between an appeal against an infringement decision and an appeal against a non-infringement decision. The Tribunal considered that, in complainants' appeals, the complainant would normally need to persuade the Tribunal

> "that the decision is incorrect or, at the least, insufficient, from the point of view of (i) the reasons given; (ii) the facts and analysis relied on; (iii) the law applied; (iv) the investigation undertaken; or (v) the procedure followed" (*Freeserve* at paragraph 114).

244. That check list applies in our view in the present case where the Director has taken a formal non-infringement decision. The complainant, Albion, is not limited to the evidence that was before the Director (*Freeserve*, at paragraph 116).

245. Under paragraph 3 (2) of Schedule 8 of the 1998 Act, read with section 31 (4A) of the WIA91, the Tribunal may "confirm or set aside the decision… or any part of it" and may (a) remit the matter to the Director … (d) give such directions, or take such other steps, as the Director could himself have given or taken, or (e) make any other decision which the Director could himself have made". The circumstances in which the Tribunal may exercise its powers under paragraph 3 (2) (e) of Schedule 8 were the subject of some discussion in *Burgess,* cited above, at paragraphs 128 to 139.

B. BURDEN OF PROOF

246. We accept that, in order to find an infringement of the Chapter II prohibition, the Director needed to be satisfied that each of the elements referred to in section 18 of the Act were established on the balance of probabilities. In the Decision, the Director (at paragraph 340) applied the approach of the Tribunal set out in *Napp Pharmaceutical*

*Holdings v. Director General of Fair Trading* [2002] CAT 1, at paragraphs 108 and 109. That passage has since been further commented on by the Tribunal in *JJB Sports and Allsports v. OFT* [2004] CAT 17, at paragraphs 197 to 208. The latter passage makes clear that the balance of probabilities is the standard to be applied: see also *The Racecourse Association and others v. OFT* [2005] CAT 29, at paragraph 131.

247. At the stage of an appeal to the Tribunal we accept that Albion bears the burden of persuading the Tribunal that it is necessary to set aside the Decision, in whole or part, on one or more of the grounds set out in *Freeserve*. We note, however, that in this particular case most of the relevant information is in the hands of the Director and Dŵr Cymru, and that Albion has access only to information which is publicly obtainable. Although Dr Bryan has considerable experience of the water industry, Albion is a company with limited resources, in part as a result of the effect of the present dispute. In these circumstances it seems to us that it is appropriate, if necessary, for the Tribunal to use its powers under the Rules of Procedure to ensure that the information necessary to decide the issues is in fact before the Tribunal. We do not understand the Director to take a different view. If it is necessary for the Tribunal itself to make findings of fact in the course of this appeal, the relevant standard is the balance of probabilities, see *Burgess*, cited above, at paragraph 120.

## C. SOME PRELIMINARY OBSERVATIONS

*Features of the industry*

248. There is no doubt that the water industry has a number of special features. The industry has a large capital infrastructure with high "sunk" costs. The cost of renewing and maintaining the infrastructure, much of it constructed many years ago, is high. Overhead costs of one kind or another represent the major proportion of total costs, whereas operating costs, generally speaking, represent a significantly lower proportion. There is also a high proportion of joint and common costs, where it is difficult to allocate the different costs and overheads of the network as a whole to particular customers. Prices, at least in the household sector, have been traditionally averaged across customers. The industry has various universal service and social obligations, such as providing water for fire fighting, ensuring supplies in rural areas, and taking

into account the interests of vulnerable customers, as well as ensuring the safety of the public drinking supply and protecting the environment. The regulatory system established by WIA91 seeks, so far as it can, to encourage efficiency, but at the same time to ensure that adequate returns are obtained in order to encourage much needed investment in the infrastructure.

249. Suppliers have hitherto been vertically integrated, with the functions of abstraction, treatment, distribution and retailing of water being carried out within the same company. Unlike other network industries such as gas, electricity or telecommunications there is no national grid for water. Until comparatively recently, most customers have had no possibility of obtaining water supplies other than from the vertically integrated monopoly supplier in the local area.

*Attempts to introduce competition*

250. Against that background, it appears that for many years Governments of both main parties have sought to introduce a degree of effective competition in relation to the supply of water to large users. The first move in this direction was the introduction of inset appointments under the Competition and Service (Utilities) Act 1992. At the material time inset appointments could be sought in respect of supplies above 100Ml (250Ml in Wales). Although, according to DEFRA, the possibility of such appointments "has sharpened incentives for undertakers to introduce lower tariffs and better services for their larger users", the impact of inset appointments has been "muted" (Consultation Paper, paragraph 19). Albion's inset appointment is the only appointment of a company that was not previously a statutory water undertaker, and few others have been made.

251. The next attempt to introduce a degree of effective competition for large users was based on the coming into force of the 1998 Act in March 2000. In OFT 422, and in the successive MD Guidance Notices referred to above, the Director made it clear that he saw common carriage as an important means of introducing competition in the water industry. The Director's consistent efforts to encourage common carriage culminated in the issue of the Director's publication *Access Codes for Common Carriage – Guidance* in March 2002.

252. In fact, however, hardly any common carriage has occurred. Although the Tribunal asked in the course of these proceedings why that was so, no clear explanation has been put forward. The preparation of the various Access Codes by the statutory undertakers pursuant to the Director's *Guidance* seems to have been in practice an empty exercise.

253. Apart from this case and the Bath House case, there appear to have been few serious attempts to obtain common carriage, notwithstanding the Director's endorsement of common carriage both in his *Guidance* under the 1998 Act and in his MD Guidance letters between 1999 and 2002, in force at all material times.

254. The third effort to introduce competition for large users is illustrated by the Consultation Paper published in July 2002, which led to the WA03. The Consultation Paper continued to emphasise the importance of competition in the supply of water to large users, while doubting whether competition was as appropriate in the household sector. At paragraph 28, the Consultation Paper said:

> "There are a number of factors that make competition for large users practicable. Unlike household customers, cross-subsidies have been largely unwound. Large users often have individual service requirements that are suited to individual contractual arrangements. Large users are charged on the basis of measured volume and, therefore, it is easier to establish how much water a new entrant's customers are using and apportion distribution costs. There may also be opportunities for local competition where a small source of water, that might otherwise be uneconomic for an undertaker to develop, could be used to supply a particular customer."

255. The Consultation Paper noted that the regulatory system:

> "lacks key features of market competition, most notably the threat of market entry and customer choice. The incentives to increase efficiency, improve the quality of service, introduce innovative practices and drive down prices may, therefore, be somewhat weaker than those provided by direct market competition." (paragraph 17)

256. As regards the benefits of competition for large users in the water industry, the Consultation Paper noted:

> "Extending competition is expected to deliver the following benefits:

> **Choice** – at present, customers cannot choose to remove their custom from an unsatisfactory supplier, as there is only one undertaker in their area. New entrants should bring wider choices of tariff and services to attract specific customers.
>
> **Keener prices** – from new entrants and through competitive pressure on incumbents.
>
> **Services** – there may be scope for niche marketing in other areas in which incumbents have not previously concentrated. Some new entrants may offer to provide multi-utility supply packages and other services. Competition provides an incentive to provide a service which matches customers' requirements, in order to obtain and keep customers.
>
> **Innovation** – new entrants may offer new ways of doing things, bringing ideas from other industries, which may bring service and environmental benefits. For example, there should be incentives to find ways to develop previously unusable/uneconomic water sources, and to use existing resources more efficiently.
>
> **Efficiencies** – competitive pressures on undertakers and the incentives on entrants should encourage greater efficiencies, which drive keener prices and better overall value for money."
>
> (paragraph 24)

257. As already explained, the WA03 has now introduced a licensing system whereby third parties can be licensed to supply water by retail to large users having an annual consumption of more than 50Ml. It seems clear that the WA03 is notably intended to achieve the benefits of competition referred to in the Consultation Paper.

*The effect of the Decision*

258. However, the Decision in the present case is, broadly speaking, to the opposite effect. Essentially, Dŵr Cymru's common carriage price of 23.2p/m³ would make it uneconomic for Albion to supply Shotton Paper on a common carriage basis, even assuming that Albion was able to acquire the water in question from United Utilities at the existing price of 3.2p/m³, since the resulting total cost to Albion of some 26.4p/m³ would be slightly above the price that Shotton Paper is presently paying (26p/m³), even without allowing for any contribution to Albion's own costs.

259. It is also apparently the case that the Decision would have in practice the effect of largely removing the viability of Albion's inset appointment, since both the existing

terms of supply between Albion and Dŵr Cymru, and the terms envisaged by the Director for any common carriage arrangement, would equally render Albion's inset operations commercially uneconomic. Indeed, Albion has survived to this point only with the financial support of Shotton Paper, and latterly by virtue of the interim relief granted by the Tribunal.

260. While, of course, no competitor has an unqualified right to continued existence, the possible elimination of the only new inset appointee (outside of the statutory undertakers) in circumstances where the recent trend has been to encourage competition in the water industry, is a matter of concern.

261. This case also has wider ramifications, since the ECPR approach adopted in the Decision in relation to the Chapter II prohibition is the same approach as that now required, according to the Director, by the new section 66E of the WIA91, introduced by the WA03.

*The interests of the consumer*

262. We remind ourselves that the primary interest to be protected under the Chapter II prohibition is the competitive process, and ultimately the interest of the consumer, rather than the private interest of a particular competitor (here Albion). However, as the Tribunal pointed out in *Burgess* at paragraph 332, cited above, there are some circumstances in which the protection of the competitive process necessarily involves having regard to the situation of undertakings seeking to compete with the dominant firm, not with a view to protecting these competitors for their own sake, but with a view to protecting competition for the benefit of consumers. The consumers in this case are large industrial users of non-potable water, for whom water is an input like any other.

263. In that regard, the Director submitted that Albion's only role was akin to someone who intercepted the postman at the garden gate and then demanded a margin for delivering the letter from the garden gate to the front door (Day 2, p. 5, paragraph 27). In the Director's view, Albion did little more than retype the invoice it received from Dŵr Cymru, and send the retyped invoice on to Shotton Paper (Day 2, p. 5, line 32-33).

264. It is true that, at present, Albion's operations are somewhat limited, because it has no effective margin between the price it has to pay to Dŵr Cymru under the Second Bulk Supply Agreement (26p) and the retail price it receives from Shotton Paper (26p). But the focus in our view should not be on the present situation (described in Figure 1 above), but on what Albion has been trying to achieve, which is to secure a supply of water to Shotton Paper on better terms, by negotiating as a broker or a middleman to obtain the water from United Utilities, while paying a reasonable price to Dŵr Cymru for common carriage (figure 2 above). In a press release of 24 November 1997, the Director referred to inset appointments sought by Enviro-Logic: "The competitor acts as a middleman, driving down the costs of supply. This has brought benefits with companies responding by introducing large user tariffs". To seek by brokerage to achieve a better price for large industrial users seems to us to be a legitimate commercial activity.

265. We do not accept that any margin Albion might eventually obtain would be entirely to the benefit of Albion. In our view, the commercial reality is that a substantial part of any such margin would in practice have to be passed on to Shotton Paper. Clause 7.4 of the supply agreement between Albion and Shotton Paper dated 19 March 1999 provides that in various circumstances any cost savings achieved by Albion in relation to water supplies as there defined are to be shared in the proportion of 70/30 in favour of Shotton Paper. We express no view on the true construction of that clause, but whatever the precise contractual arrangement between Albion and Shotton Paper, it seems to us that the bargaining power of the latter, as Albion's only customer, would make it very difficult for Albion not to pass on a substantial part of its margin to Shotton Paper in the form of lower water prices. As the letters of Mr Baty, the Managing Director of UPM, of 15 October and 10 December 2003 make clear, Shotton Paper has supported Albion financially precisely with a view to obtaining better terms and improved service in the supply of water.

266. Against that background, we now turn to the issue of excess pricing.

## D. THE ALLEGATION OF EXCESS PRICING

### (1) THE RELEVANT LAW

267. Section 18(2)(a) of the 1998 Act gives, as an example of an abuse, "directly or indirectly imposing unfair selling prices".

268. Similar wording is found in Article 82 of the Treaty. It appears to be common ground that "unfair" is or can be equivalent to "excessive". To determine whether a price is excessive, the starting point is Case 27/76 *United Brands v Commission* [1978] ECR 207 where the Court said at paragraphs 248 to 253:

> "248 The imposition by an undertaking in a dominant position directly or indirectly of unfair purchase or selling prices is an abuse to which exception can be taken under Article [82] of the Treaty.
>
> 249 It is advisable therefore to ascertain whether the dominant undertaking has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition.
>
> 250 In this case charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse.
>
> 251 This excess could, *inter alia,* be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production, which would disclose the amount of the profit margin; however the Commission has not done this since it has not analysed UBC's costs structure.
>
> 252 The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products.
>
> 253 Other ways may be devised – and economic theorists have not failed to think up several – of selecting the rules for determining whether the price of a product is unfair".

269. The general principles were considered by the Tribunal in *Napp*, cited above, at paragraphs 386 *et seq*. In that case the Director General of Fair Trading attached importance to whether the price was above that which would exist in a competitive market, in circumstances where there was no effective pressure to bring prices down to competitive levels. The Tribunal in *Napp* did not dissent from that approach: see

paragraphs 390 to 391, and 403 of the judgment. In accordance with *United Brands* the key issue, however, is whether the price in question

> "has no reasonable relation to the economic value of the product supplied."

270. Whether a given price bears "no reasonable relation" to its "economic value" is a matter of fact and degree, which in our judgment involves a considerable margin of appreciation, not least because the notion of the "economic value" and whether the price has a "reasonable" relation to that value are matters of judgment. It is particularly a matter of fact and degree to decide how far above "the economic value" a price has to be before it can be said to bear "no reasonable relation" to the economic value.

271. A number of previous decisions have considered the question of excessive prices: e.g. Case 26/75 *General Motors v Commission* [1975] ECR 1367 (excessive charge for monopoly service); *Bodson* [1988] ECR 2479 (comparison of prices with other undertakings not enjoying exclusivity); Case 110/99 *Lucazeau v SACEM* [1989] ECR 2811 (Comparison of prices between Member States), *Ministère Public v Tournier* [1989] 2521 (high prices cannot be justified by high costs if the latter are due to lack of competition and inefficiency); *Deutsche Post AG – Interception of cross-border mail* OJ 2001 L331/40 (comparison of domestic and international tariffs where costs difficult to ascertain); and the Commission's *Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector* OJ 1988 C265/2 (the "Telecommunications Notice").

272. In the Telecommunications Notice, referred to in the Decision at paragraph 233, the Commission said at paragraph 107:

> "107 It is necessary for the Commission to determine what the direct costs for the relevant product are. Appropriate cost allocation is therefore fundamental to determining whether a price is excessive. For example, where a company is engaged in a number of activities, it will be necessary to allocate relevant costs to the various activities, together with an appropriate contribution towards common costs. It may also be appropriate for the Commission to determine the proper cost allocation methodology where this is a subject of dispute."

273. Paragraphs 4.9, 4.10 and 4.19 of OFT 414, cited above, also show the importance of a proper assessment of costs in cases of allegedly excessive pricing.

(2) THE AVERAGE ACCOUNTING COST APPOACH

274. Dŵr Cymru quoted Albion a First Access Price of 23.2p/m³. Applying an average accounting cost approach, which is accepted by all parties as an appropriate approach, the Director reached the view that the correct price should have been 19.2p/m³. However, he declined to find Dŵr Cymru's First Access Price to be an infringement of the Chapter II prohibition, because the Director's alternative ECPR approach gave rise to a price of 22.5p/m³. We discuss the ECPR issues in the next section. In this section we are concerned with Albion's criticisms of the Director's average accounting cost approach.

275. It is common ground that the relevant accounting costs in this case are (a) the costs of treatment and (b) the costs of distribution.

276. As regards the cost of treatment, the parties are not, relatively speaking, that far apart. Albion's calculations have yielded a figure of 2p/m³, whereas the Director's figure is 3.2p/m³. The Decision calculates operating costs at 2p/m³ (paragraph 17 of Annex I). Bearing in mind that there will always be some degree of estimation we are prepared to assume at this stage, without deciding, that treatment costs are in the range 2p/m³ to 3.2p/m³.

277. The key consideration is, however, distribution costs, for which the Director's figure is 16p/m³. The Decision calculates operating costs at 1p/m³ (paragraph 17 of Annex I) apparently leaving 15p/m³ out of 16p/m³ representing costs other than operating costs. Indeed, even accepting the Director's figure for treatment costs of 3.2p/m³, with 1p/m³ for the operating costs of distribution; that still leaves some 15p/m³ out of the Director's calculation of 19.2p/m³ to be accounted for by costs other than direct operating costs.

278. In round terms, 15p/m³ represents a cost to Albion (and indirectly to Shotton Paper) of some £1 million per annum. In our view, it is crucial to the correctness of the Director's calculations that that distribution cost element is fully justified.

279. Although not appearing very clearly from the Decision, it turns out that the source of the estimate of 16p/m³ for distribution costs for non-potable water is the calculation of distribution costs made by Dŵr Cymru in 1999 when the Large Industrial Tariff was introduced for large users of potable water. It appears to be common ground that the figure of 16p/m³ relates to the bulk distribution cost of supplying potable water to large users with an annual consumption of over 1000Ml per annum.

280. Albion criticises the figure of 16p/m³ by six different methods already summarised above.

*Albion's first method: the profitability of third party services*

281. Albion's first method of constructing a reasonable common carriage price is to seek to create on the basis of published information a profit and loss account for "third party services" which fall outside the main regulatory system. According to the Regulatory Accounting Guidelines (RAGs) published by the Director, "third party services" include the supply of non-potable water. The Director's answer to Albion's first method is essentially that the RAGs and Dŵr Cymru's published figures in its June return are inconsistent, owing to "definitional ambiguities", so the exercise is unreliable. In addition, says the Director, "third party services" is a residual miscellaneous category in the regulatory accounts from which it would be difficult to identify "the profit" from non-potable water, not least because of the difficulty of establishing the capital to be attributed.

282. In RAG 4.02 for 2002/2003, companies are required to analyse costs and assets for their regulatory accounts in the manner there set out. These costs are the direct costs attributable to the relevant activity, excluding costs which are recorded only at service level (rates, bad debts, exceptional items and write offs) and costs that are capitalised, but apparently including costs of management, supervision and administration that can be directly attributed (RAG 4.02, at 3.2). Various categories of cost are then defined.

283. Under the heading "Water Resources and Treatment" companies are required to exclude "the functional costs of bulk water supplied to third parties and of non-potable water", and to make "compensating adjustments" under the heading "Services provided

to third parties". Similarly under the heading "Distribution of treated water" it is said that "The costs of distributing non-potable water" should be excluded (paragraph 3.2.4). Under the heading "Services provided for third parties" companies are required to include notably "the cost of bulk supplies of raw or treated water supplied to other companies" and "the cost of providing and delivering non-potable water". Paragraph 3 of the annex to that document is to the same effect.

284. It appears that the supplies of non-potable water with which this case is concerned are in fact intended to be accounted for under the heading "Third Party Services" and not under the headings "Water Resources and Treatment or "Water Distribution".

285. We find it somewhat surprising that the above paragraphs of the RAGs are not apparently reflected in the June returns, apparently because of "definitional ambiguities". However, we accept the Director's general point that the accounting heading "Third Party Services" is a miscellaneous category of activities for which it could be difficult to establish a "stand alone" profit and loss account, at least without a considerable amount of effort. Mainly for that reason, we are not persuaded that Albion's first method is a useful or reliable way of establishing a reasonable common carriage price.

286. Albion's first method, does, however, draw attention to two matters that have a wider significance for this case. The provisions of RAG4, cited above, seem to indicate: (i) that the costs and revenues of producing and delivering non-potable water are in the view of the authors of the RAGs identifiable; and (ii) that, in broad terms, the costs and revenues of producing and delivering non-potable water are apparently excluded by the Director from the information he requires for the purpose of exercising his main regulatory price reviews. We bear these points in mind in our analysis below.

*Albion's second, third, fifth and sixth methods: the difference between potable and non-potable distribution cost*

287. By these different methods, Albion seeks in one way or another to show that the distribution costs of non-potable water are lower than the figure of 16p/m $^3$ assumed by the Director and are, in particular, lower than the cost of distributing potable water, contrary to paragraphs 300 to 302 of the Decision.

288. Albion's second method, and to some extent its third and sixth methods, are predicated on the argument that the Ashgrove system should be treated as a raw water aqueduct, and is classified as such in Dŵr Cymru's asset inventory.

289. More particularly, in its third method Albion puts in issue the findings in paragraphs 300 to 302 of the Decision to the effect that the cost drivers for the bulk distribution of potable water are the same as the cost drivers for non-potable water. Albion relies in particular on the contentions that non-potable mains tend to be shorter in length, of lower integrity, maintained at lower pressure, lower in throughput and less costly to lay and maintain (because they are largely laid in rural, rather than urban areas). In its third and sixth methods Albion also advances various specific calculations, which it says show that, on the Director's figures, the cost recovery (calculated as £ per kilometre or MEA value per kilometre) is much less for non-potable mains than for potable mains. In its fifth method Albion further takes the various cost elements apparently used by Dŵr Cymru for the establishment of the Large Industrial Tariff for potable users in 1999, and argues that a large proportion of those costs elements are not relevant to non-potable water.

290. The Director's response to these various points is, essentially, that the Ashgrove system carries "partially treated", as distinct from "raw", water and cannot be assimilated to a raw water aqueduct; that Albion has made insufficient allowances for common costs, overheads and capital costs; and that Albion's arguments as to the physical differences between potable and non-potable mains distribution are mere assertions. For example, says the Director, non-potable mains may equally be of high pressure, whereas potable mains can also be situated in rural areas. Moreover, if one makes a correct comparison of the figures, in particular including 300mm as well as 600mm pipes in the non-potable system, the relevant figures in £ per kilometre are broadly equivalent for non-potable and potable distribution mains, on the Director's figures.

291. Our detailed review of the material before us in the light of the focus of the hearing leads us to the conclusions that

    (i) it is essential that we reach an informed view on the Director's approach to distribution costs; but

(ii) at present we do not have sufficient evidence to enable us to decide this issue in a manner that would be fair to either party.

292. We note first that the Decision (paragraph 27 of Annex I) indicates that operating costs for distribution in the Ashgrove system are of the order of 1p/m³. The Director's figure in his calculations for total distribution costs is 16p/m³. The gap between those figures is in our view very large, even allowing for what is said to be the relatively low level of operating costs as a proportion of total costs in the water industry. As already indicated, it is crucial to the robustness of the Decision that the figure of 16p/m³ is a reasonable one.

293. In that regard, Albion has put before us a number of elements that raise significant doubts in our minds.

294. First, as set out above it is plain from the Director's own RAGs that for regulatory purposes the costs of the distribution of non-potable water are treated differently from the costs of the distribution of potable water (RAG 4.02, paragraphs 3.2.4 and 3.2.7). That indicates to us that for regulatory purposes the costs of distribution of non-potable water are distinguishable from the costs of distribution of potable water, the costs of the former being relegated to "Third Party Services" rather than included in the main headings of "Resources and Treatment" or "Water Distribution". That in turn suggests that there may well be differences in the different distribution costs in question.

295. Secondly, it is common ground that Dŵr Cymru in fact classifies the Ashgrove system in its asset inventories as a raw water aqueduct. The values in the inventory are presumably audited and verified. If that is correctly done for regulatory purposes, that lends some support to Albion's argument that there is a relevant difference between the function performed by Ashgrove pipeline and the function typically performed by a bulk potable distribution main which, as we understand it, is classified by Dŵr Cymru under a different heading. In its letter of 1 July 2002 Dŵr Cymru refers to the supply to Albion as a raw water supply.

296. Thirdly, we note that Albion has produced various figures prepared on a basis similar to the basis used by Dŵr Cymru in relation to treatment costs and approved by the

Director at paragraph 279 of the Decision. Albion's figures tend to show a higher cost recovery per kilometre for potable, as distinct from non-potable, mains. Although admittedly partly based on Dŵr Cymru's classification of the Ashgrove system as a raw water aqueduct, a number of alternative calculations presented by Albion seem to lead to the same conclusion. One of the Director's principal answers to this line of argument is that any comparison should include not only 600mm pipes but also the smaller 300mm pipes which are, says the Director, also relevant to non-potable systems. Albion in riposte presents figures which equally include 300mm pipes. We note, however, that when preparing the Large Industrial Tariff for potable users in 1999, for customers with an annual consumption of over 1000Ml, only 600mm pipes were taken into account. That raises a doubt in our minds as to whether it is appropriate to bring 300mm pipes into the calculation in respect of a customer such as Shotton Paper.

297. Fourthly, paragraph 179 of the notice of appeal states:

> "Non-potable mains are generally of low pressure and short length and are to be found in rural areas where construction costs are low. By contrast, the trunk potable network is of high pressure and must be of high integrity to protect the quality of the water. Potable trunk mains are usually laid under the roads, very often in urban situations, and their construction and maintenance costs are correspondingly high. It is inconceivable that non-potable mains could have a higher unit cost than potable mains; let alone a cost that is [20] times higher."
>
> (see also Albion's then solicitors' letter of 14 May 2002)

298. Although Albion has produced no specific witness statement in support of paragraph 179 of the notice of appeal, Albion's Managing Director Dr Bryan has signed a statement of truth in support of the facts stated in the notice of appeal (p. 2). Dr Bryan states in two witness statements dated 23 July 2004 and 11 March 2005 that he is a qualified water scientist with an honours degree in microbiology and chemistry and a doctorate in the biological processes associated with water pollution. He has been employed within the water and environmental sector for 32 years and has held senior posts for much of that time. He states that he has been able to gain experience across the full range of services provided by the water and sewerage industry, from scientific, operational, and regulatory perspectives, both nationally and internationally. The

Tribunal therefore has at least some evidence before it to support Albion's contentions as to the physical differences between potable and non-potable distribution. No evidence on this issue has so far been filed on behalf of either the Director or Dŵr Cymru.

299. The key passage in the Decision is at paragraphs 300 to 301:

> "The main cost drivers for transporting water through pipes are linked to the size (diameter) and the material and smoothness of the pipe, required flow rate, distance, direction and change in altitude between the points at which the water enters and leaves the pipe. These cost drivers are largely independent of the quality of the water being transported.
>
> In practice, the differences in the physical characteristics (density and viscosity) of partially treated non-potable water and potable water would be minimal in so far as they could directly affect the costs of water distribution. It does not therefore appear that the cost of transporting a given volume of water is fundamentally affected by whether the water is potable or non-potable."

300. Albion does not challenge the relevance of the cost drivers identified at paragraph 300 of the Decision, and accepts that water quality (in terms of the difference between potable and non-potable water) is not a factor: paragraph 85 of annex 2 to the notice of appeal. Albion's case, as we understand it, is that the identified cost drivers do not apply in the same way to potable and non-potable water, notably because the distance element in the case of potable systems is much greater, and for the other reasons set out above.

301. In the light of all the foregoing considerations, we have considerable doubts as to whether the material presently before us is sufficient to support the conclusion at paragraph 303 of the Decision that it was reasonable for Dŵr Cymru to treat the distribution costs of potable and non-potable water as the same. In any event, we do not think at the moment that we have sufficient hard evidence to enable us satisfactorily to determine this point, which is also relevant to other aspects of this case.

302. Subject to the views of the parties, the following is indicative of the matters upon which the Tribunal would wish to consider hearing further evidence, or alternatively agreement between the parties as to:

(a) The geographical whereabouts, lengths and pipe sizes of Dŵr Cymru's systems for the bulk supply of potable and non-potable water respectively, including clarification of the basis of the distinction being drawn between what is a "raw water aqueduct" and what is "a non-potable main" and what is regarded as "bulk" distribution and a "trunk" main";

(b) What if any is the physical difference between what is said to be 158 km of non-potable mains, as distinct from some 542km of raw water aqueduct;

(c) Whether the correct length to take for Dŵr Cymru's potable bulk distribution system is 440km or 1834km, and on what basis;

(d) What are the reasons for and implications of classifying the non-potable Ashgrove system as a raw water aqueduct;

(e) What are the reasons for excluding non-potable distribution costs from the headings "Water resources and treatment" and "Water distribution" in the RAGs;

(f) To what extent there are significant and/or relevant physical differences between the non-potable water supplied through the Ashgrove system and typical "raw" water supplied from a reservoir to a Dŵr Cymru water treatment plant, and what implications if any that has for the assessment of distribution costs;

(g) Whether, and if so on what basis, 300mm mains are relevant to the analysis;

(h) Whether there are any differences in the relevant cost drivers for potable and non-potable distribution costs respectively, arising from any differences in (i) construction and maintenance costs; (ii) typical

location; (iii) pressure and/or throughput; (iv) distance; or (v) any other factor, and the significance of any such differences.

(i) Whether any costs identified as included in the calculation of potable distribution costs at the time of the introduction of the Large Industrial Tariff are not incurred, or are incurred to a lesser extent, in relation to non-potable distribution.

303. It seems to us that these relatively objective matters should not be difficult to establish, if possible by agreement. Much of the information will, presumably, be in the hands of Dŵr Cymru and can either be agreed or disclosed. Some matters, such as whether the Ashgrove system is functionally different from a typical raw water aqueduct, or the relevance of different cost drivers, may require some expert evidence. The Tribunal has power under Rules 19(2)(l) and 55(5) of the Tribunal's Rules of Procedure[28] to appoint and instruct its own expert. We would be glad to have the parties' observations on whether that, or any other step, would be best calculated to resolve the outstanding factual issue of the comparative cost of the distribution of bulk potable and non-potable water respectively, as conveniently as possible.

*Albion's fourth method: the costs of the Ashgrove system*

304. In its fourth method, Albion relies on the costs of the Ashgrove system, based on the disclosure in these proceedings of a calculation of local costs apparently carried out by Dŵr Cymru in 1995/1996 in connection with what became the Second Bulk Supply Agreement. That document (reply D21) gave rise to a figure of 19.6p/m³ for the bulk supply of non-potable water, including 6.2p/m³ for what is described as "Management on-cost". Those figures would give a common carriage price of 16.1p/m³, subtracting the resource cost of 3.5p/m³. The 1995/1996 figure was said by Dŵr Cymru to approximate to a common carriage price of some 20p/m³ in 2001/2002 terms.

305. Albion's essential argument is that the figures in this document proceed on the basis of excessive asset values, depreciation charges and infrastructure renewal charges. Properly corrected, the figures would give a total cost of 12.93p/m³, which would

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equate to 9.39p/m³ if one subtracts the cost of resources (3.54p/m³). From that Albion seeks also to subtract Albion's own estimate for retail cost (4.8p/m³) to arrive at a common carriage price of 4.59p/m³, which would apparently include 2.01p/m³ for treatment costs (p. 16 of annex 2 to the Reply). Albion also suggests, in what appears to be a different calculation on the basis of these figures, that distribution costs can be calculated at 4.139p/m³ (p. 27 of annex 2 to the reply). Albion further points out that in 1995/1996 Dŵr Cymru produced a different cost calculation for distribution costs (notice of appeal 9/8).

306. The Director's essential response to these arguments is twofold: (i) local costs are "irrelevant", and the only practical and principled way of assessing costs is by reference to regional average costs; and (ii) the various figures relied on by Albion are insufficiently robust to enable any conclusions to be drawn.

307. The questions for the Tribunal are: (i) whether Albion's fourth method is potentially relevant to the application of the Chapter II prohibition in the present case; and (ii) if so, whether that method is sufficiently robust to enable any reliable conclusions to be drawn.

308. By "regional averaging" we understand the Director to mean that costs should be averaged geographically across similar customers in the region using what is conventionally described as a "top down" approach. For example, to arrive at the common carriage price in this case, Dŵr Cymru took first the average potable and non-potable revenue received by Dŵr Cymru across all customers (excluding certain bulk supplies). Then in a series of steps Dŵr Cymru progressively subtracted various average costs to arrive at an average figure in p/m ³ for the treatment and distribution of non-potable water, as described in the Decision.

309. As we understand it, Dŵr Cymru uses a similar procedure when it comes to setting tariffs. One of the Director's principal concerns in this case, among others, is that in his view there would be a potentially adverse effect on tariff setting if the principle of "regional average" costs was departed from.

310. The alternative approach reflected notably in Albion's fourth method, is known as "bottom up". This approach starts with calculations of the costs of the Ashgrove system (including charges for depreciation/infrastructure renewals, a return on capital and a contribution to common costs described as "management on-cost") and then divides those costs by the throughput, again to arrive at a cost-based figure for common carriage in p/m $^3$. If Ashgrove's costs were close to the average, this would also be a way of arriving at a regional average cost.

311. In a competitive market, the "top down" and the "bottom up" approaches should, as it were, meet in the middle, giving rise to the same result, unless there is some reason to suppose that the local costs in a particular case differ significantly from the average: see *Claymore v OFT* [2005] CAT 30 at paragraph 228, decided after the argument in the present case. In *Claymore,* where there was considerable difficulty in determining the costs of supply to individual customers, the Tribunal expressed the view that, in the particular circumstances of that case, a "top down" approach would have been more likely to ensure that all relevant cost information was included but that, whichever approach were adopted, sufficient cross-checks should be made to ensure that the relevant cost information was reliable.

312. The Director's essential objections to a "bottom up" approach in this case are that in the water industry local costs data is unaudited, and/or unavailable or unreliable, and that the attempt to use such data on a local basis could in any event cause unacceptable distortions between customers. However, he stresses that he is not opposed to seeking to make prices more reflective of the different costs of supply to different kinds of customer. Indeed, the Director has encouraged undertakings to reflect such different costs of supply in their various charges and tariffs, for example, to household and non-household customers, according to the size of the user, whether the water is potable or non-potable, or delivered in bulk and so on. It is only different prices to customers *on the basis of their geographical location* to which the Director takes objection.

313. We accept the Director's point that any cost figures used for a "bottom up" calculation should be robust and verifiable. We also accept that in many cases it may be convenient to use an "average" figure as a proxy for the "local" cost of serving an individual customer. That may indeed be the situation in the present case where,

according to the Director, the vast majority of the costs shown in the document on which Albion relies (reply D21) are based on "regional and generic assumptions" (rejoinder, p.76).

314. We also accept that any attempt to identify "local" costs should include an allocation to reflect the common costs of the system. A water undertaker will have general overheads, including universal service obligations. In competitive markets, prices will normally reflect the need to recover general overheads. Again, "common costs" appear to be included in the calculations on which Albion relies, which include 6.2p/m³ (about one-third of total costs) for "management on-costs". The calculations also take account of capital costs at replacement values, and a rate of return.

315. In the present case document D21 is largely based on various "average" figures, as the Director submits. In addition Shotton Paper itself accounts for over a fifth of Dŵr Cymru's non-potable supplies, and Shotton Paper and Corus together for over one-quarter. Ashgrove would, therefore, constitute a major proportion of the average. It is not clear to us that Ashgrove's costs would in fact be lower than the non-potable regional average.

316. In these circumstances we find it difficult to say that figures for the costs of the Ashgrove system are potentially "irrelevant" as the Director submits, assuming that such figures can be appropriately verified. One particular potential relevance of such figures in our view is as a cross-check against the Director's "top down" calculations. Indeed, since the RAGs appear to require the costs of non-potable supplies to be separately identified, we are not at present clear why it would be difficult to establish the average cost of non-potable supplies on a bottom-up basis.

317. In our view three particular considerations suggest that such a cross-check could be appropriate: (i) the Director's "top down" approach involves a long chain of allocations, starting with the general costs of supplying about 1.3 million customers of Dŵr Cymru and arriving finally at the costs of supply of some 7 or 8 large customers of non-potable water, with a consumption above 1000Ml: such an extended calculation inevitably has scope for error; (ii) the figures in the Director's top down approach are disputed and document D21 may help to resolve that dispute as a cross-check; (iii) in a

Chapter II case of excessive pricing it would be unusual not to seek to ascertain the "stand alone" cost of producing the product in question: see e.g. paragraphs 4.9, 4.10 and 4.14 of OFT 422, cited above, and paragraph 107 of the Telecommunications Notice. Indeed, in normal competitive conditions, the costs associated with supplying the particular customer in question would normally be a relevant factor in negotiating the price.

318. The Director, however, argues that the costs of the Ashgrove system are "irrelevant" because of the potential effect of "regional de-averaging".

319. The issue for us is not the pros and cons of regional averaging in a general sense, but whether it can be said that the costs of the Ashgrove system are "irrelevant" for the purposes of the present Chapter II case because of regional "de-averaging" considerations. Our overall conclusions at present are (i) that the issue of geographic "de-averaging" is highly important in the household sector with which this case is not concerned, but is of much less relevance as far as very large customers of non-potable water are concerned; (ii) we are not yet persuaded that, because of regional de-averaging, the costs of the Ashgrove system are "irrelevant" to the particular Chapter II investigation in this case.

320. We accept that within the sector of largely household customers it would be extremely difficult to determine different costs of supply for differently situated customers, and that for social and practical reasons the principle that tariff customers should pay the same charges irrespective of their precise location is well established and long standing. It has long been accepted, for example, that the rural customer should pay the same as his urban counterpart, or vice-versa, even if different costs of supply could be identified. This is recognised in the Consultation Paper at paragraphs 26 to 27:

> "26. Very careful consideration has been given to whether to introduce measures to increase competition for household customers in the prospective Water Bill. There are a number of factors to be taken into account. Water is heavy and costly to distribute (compared to its final selling price) and there is no national grid to distribute it. There are also cross-subsidies within household tariffs which competition could unwind. Prices are averaged across undertakers' areas, for example, so that people who live where water is expensive to treat and transport,

which includes many rural communities, pay the same tariff as those in areas where costs are lower.

27. Increasing competition for households, while at the same time seeking to ensure that the Government's public health, social and environmental objectives continue to be met, would require a complex and costly regulatory regime, which would still leave substantial uncertainties, particularly about the effects on individual customers' bills. The added complexity would militate against effective competition and the extra costs would have to be borne mainly by customers. The Government believes that, based on evidence currently available, the drawbacks of increasing competition for household customers are likely to outweigh the potential benefits. The legislative provisions in the Water Bill will therefore prohibit new entrants from supplying water to household customers through undertakers' distribution networks."

321. As the Director put it in argument:

> "…so for example take household customers, the people who live in terraced houses are not charged a lesser amount than the farmer who lives way out in the valley simply because he is way out in the valley. That is what average cost pricing is all about" (Day 2, p. 15).

322. However, that example is in our view a long way from the present case, which concerns the largest industrial users of non-potable water. As paragraph 28 of the Consultation Paper, cited above, makes clear, competition for large users is considered to be practicable, not least because

> "Unlike household customers cross-subsidies have been largely unwound"

323. At paragraph 176 of the Consultation Paper it is stated under the heading "Re-balancing" that

> "Undertakers can be expected to seek to respond to the threat of competition in a number of ways. Ideally this response should lead to further efficiencies, bringing lower prices and/or higher levels of service for existing customers. But some customers, even among large users, will be less attractive to new entrants than others. Undertakers may seek to rebalance charges among this group in the light of the new competitive threat. The existing legal and regulatory constraints will apply to potentially anti-competitive practices of this type. *However, Ofwat believes that there are no significant cross-subsidies between eligible and ineligible customers. In general,*

> *undertakers will be unable to justify increasing prices to ineligible customers in order to fund price reductions to eligible customers*.
>
> (emphasis added by the Tribunal)

324. The above passages indicate that, in practice, the regional geographic averaging of costs does not presently involve significant cross-subsidies between household and non-household customers, or between customers above what is now the eligibility threshold of 50Ml under the WA03 and customers below that threshold.

325. We also note that the prices with which we are concerned in this case fall outside the "tariff" basket used for the purpose of price reviews, so in principle do not affect the vast majority of customers whose prices are regulated by that process. In the case of non-potable supplies, revenues for these are included only in the miscellaneous category of Third Party Services and appear to be regarded as being of minor importance in the regulatory context.

326. The Consultation Paper at paragraphs 269 to 271 also emphasises that some undertakers have separate distribution networks for non-potable water, and expresses the view that non-potable water services provide substantial competitive opportunities. On the information set out in the Consultation Paper, non-potable water is almost entirely supplied to large industrial users, and appears to account for only a small proportion – apparently between 1 and 2 per cent – of water undertakers' total revenue.

327. In normal competitive circumstances, prices will tend to be lower for those customers in respect of whom supply costs are lower, whether that is because of the volume of the water they take, the quality of the water they require, or their geographical location. That in our view is the natural result of competition and would normally tend to lead to a more efficient allocation of resources, particularly where large users are concerned. For example, a large user A may have consciously sited his plant close to a river so as to reduce the cost of supply whereas another large user B may have sited his plant further away near the top of a hill. In a competitive market A would not expect to pay the same price as B if his costs were different: he would expect to reap the benefit of his wiser investment decision and not cross subsidize B at the top of the hill.

328. As already stated, the Director recognises that "de-averaging" should properly occur to reflect such factors as water quality and volume, and whether the customer is household or non-household. At present we find it difficult to resist the conclusion that the introduction of competition through common carriage for large users should inevitably bring into the equation geographic location, possibly resulting in cheaper prices for some large users. As regards such large users, what the Director described as "cherry-picking" seems in reality to us to reflect the operation of market forces. Nor would we accept that lower prices for some large users would necessarily bring higher prices to other customers, not least since competition itself brings greater efficiency, savings in costs and innovation.

329. Moreover, the evidence in the present case is that at the top end of the scale prices for customers on the Large Industrial Tariff taking over 1000Ml are based on "averages" of only two customers. The same is true in the case of the New Tariff for large non-potable users over 1000Ml per annum introduced in April 2003. In the present case it could at most be a matter of "de-averaging" where only a very few large customers are concerned.

330. In the case more specifically of large non-potable users, as far as we know, all the supplies to major non-potable customers have historically been made on special agreements which the Director seems to accept as a "hybrid" kind of de-averaging. The New Tariff did not come into existence until after Albion's complaint was made. Our understanding also is that, at the time of the hearing, few of Dŵr Cymru's large non-potable users were actually on the New Tariff. There are only apparently around 13 non-potable users who could qualify for the New Tariff, of whom only about eight take above 1000Ml per annum.

331. As at present advised, and subject to further argument if necessary, we would not have thought that different prices arising from competition for the business of such large non-potable users would necessarily lead to "undue" discrimination by water undertakers contrary to condition E of the instruments of appointment, if price differences were based on the different costs of supply to the particular customer in question.

332. The Director points out that paragraph 187 of the Consultation Paper states:

> " – Undertakers' prices for distribution and wholesale supply should not, in themselves, deter potential licensees from seeking to supply customers. This implies that they should reflect the actual cost of providing the service, they should not be unduly discriminatory and they should be transparent.
>
> …
>
> – To the extent that undertakers' tariffs reflect a geographical averaging of costs, access and wholesale charges should generally be set in order to avoid the unwinding [of] the associated cross-subsidies"

333. The first indent of paragraph 187 of the Consultation Paper indicates that it is relevant to consider the "actual costs of supply". As regards the reference in the last indent, to tariffs which "reflect geographical averaging of costs" and to the need to set access and wholesale prices to "avoid unwinding the associated cross-subsidies," we have already noted that it is said elsewhere in the Consultation Paper (at paragraphs 28 and 176) that in fact there are no significant cross-subsidies to unwind in relation to large industrial users. That seems to us on our present information to be particularly so in the specific case of the supply of non-potable water to large users such as Shotton Paper, since prices to large users in this sector have traditionally been set in special agreements and not on the basis of a geographical averaging. Although the New Tariff has formally existed since 2003, few customers have been charged under that tariff, and it appears to be based on "averages" only to a limited extent.

334. In all those particular circumstances we do not accept that in the specific case of large users of non-potable water in excess of 1000Ml per annum, the various arguments against regional de-averaging are sufficiently strong or persuasive as to override the normal approach under the Chapter II prohibition, which would be to consider, as one element of the analysis, "the stand alone" cost of supplying the customer in question (OFT 422, at 4.14). By virtue of section 2(6A) of the WIA91 the Director's functions under the 1998 Act displace his duties under section 2 of the WIA91, but we are unpersuaded that there is any real conflict between the two in the case of large users of non-potable water.

335. We would therefore find it hard to accept that it is "irrelevant" to consider the costs of the Ashgrove system in order to determine the Chapter II issues that arise in the present case, especially since those costs are apparently largely "average" costs anyway.

336. However, we accept the Director's submission that any "bottom-up costs", whether for the Ashgrove system or for supplies to non-potable users generally, would have to be reliable and verifiable. At present, document D21, on its face, would appear to lend some support to the Director's case. However, to determine whether Albion's challenge to those figures was correct would seem to us to require further evidence, including possible accounting evidence. The same would be true of any "bottom up" calculation for non-potable users generally. In our view we now need to hear the parties on whether the Tribunal should seek any further evidence on these points, or whether for practical purposes it is sufficient to investigate further the Director's calculation of average non-potable bulk distribution costs, along the lines already indicated.

(3) ECPR AND RELATED ISSUES

337. At paragraphs 317 to 331 of the Decision the Director applies an additional approach, known as the ECPR, to determine whether Dŵr Cymru's First Access Price was an abuse under the Chapter II prohibition. The ECPR calculation relied on by the Director would give a First Access Price of 22.5p/m³ as against 19.2p/m³ arrived at by the Director on an average accounting basis, and the 23.2p/m³ First Access Price quoted to Albion by Dŵr Cymru.

338. The difference between the average accounting cost access price of 19.2p/m³ and the ECPR access price of 22.5p/m³, represent about £218,000 per annum in revenue. It thus seems to us necessary to determine whether the Director's approach under the ECPR is compatible with the Chapter II prohibition.

*ECPR in general*

339. The Efficient Component Pricing Rule[29] was described by the Director in MD 163 in these terms:

> "[ECPR] can be summarised by a simple equation in which the access price is given by the incumbent's final product price less the costs it would avoid by providing access. For example, a new entrant wishing to access an incumbent's arterial and local distribution network would be charged the difference between the incumbent's final product price and the avoidable costs of resources, treatment and customer service."

340. ECPR is known in shorthand as a "retail minus" approach. The theory of ECPR, as we understand it, is that if the final product price is £10, and the incumbent avoids costs of £3 by not supplying the final customer itself, then the access charge should be £7. In those circumstances, a more efficient entrant will enter the market if his other costs are less than £3 (say £2). This lower cost will then enable the new entrant to charge the final customer (say) £9. In these circumstances, so it is said, entry is "efficient", since the product in question is being supplied at the lowest total cost to society (£9 rather than £10), while at the same time the incumbent is recovering all his common and fixed costs, including "sunk" costs, as well as a return on capital.

341. Although paragraph 320 of the Decision states that ECPR has been part of regulatory literature for the past decade, the Decision at paragraphs 321 and 322 cites only the views of a well known private consultancy National Economic Research Associates (NERA), as set out in two reports commissioned on behalf of Northumbrian Water, one of the statutory water undertakers. The Decision does not contain a discussion of the Director's own views as to the advantages or disadvantages of ECPR, nor does the Decision refer to any research undertaken by the Director.

342. Paragraph 323 of the Decision states that

> "Access prices calculated under an ECPR approach may be perceived as being more favourable to undertakers than prices derived from other approaches, including some alternative retail-minus approaches. This is because ECPR allows the undertaker to produce prices that fully compensate it for the net losses that it would incur when providing a common carriage or wholesale distribution service, as compared with continuing to supply the final customer itself…"

[29] The use of the word "efficient" is somewhat controversial, since it is not always clear what kind of "efficiency" is being referred to or how that relates to effective competition.

343. That is confirmed in the present case where the ECPR approach produces a higher access price than the average accounting cost approach, by some 17 per cent.

344. The Decision does not contain any real discussion as to how or why an approach that is more favourable to the incumbent dominant undertaking than other, including other retail minus, approaches, is consistent with the Chapter II prohibition, or is to be preferred to any of these other approaches.

345. At the hearing of this matter, the underlying effects on competition of an ECPR approach were not debated, nor was the Tribunal taken to the NERA reports referred to in the Decision. However, in the light of the submissions made at the hearing, including those of Aquavitae, the Tribunal has felt it necessary to examine the NERA reports and the underlying cases and literature there referred to more closely, with a view to considering, in as informed a manner as possible, whether the particular ECPR approach adopted in this case is compatible with the Chapter II prohibition.

346. It appears that the ECPR was primarily developed by two American economists, Professors Baumol and Willig, in the early 1990s. It is sometimes referred to as the "Baumol-Willig Rule", although we will refer to it as the ECPR. The ECPR was invoked in litigation in New Zealand relating to the liberalisation of the local telecommunications market. The ECPR was accepted as an appropriate pricing approach by the High Court in *Clear Communications Ltd v Telecom Corp of New Zealand* (1992) 5 TCLR 167, rejected by the Court of Appeal (1993) 4 NZBLC 103, but accepted by the Privy Council judgment of 19 October 1994, [1995] 1 NZLR 385. It appears, however, that the Government of New Zealand expressed concern at the implications of the economic reasoning relied on by the Privy Council[30] and the litigation was settled, apparently on a different basis. A subsequent report by the Ministry of Commerce and Treasury of New Zealand published in August 1995 appears to have been critical of ECPR. In a different context, ECPR was apparently rejected by the Federal Communications Commission under the US Telecommunications Act 1996, a decision upheld by the Supreme Court in 1999. However, in various other regulatory contexts some versions of ECPR have been used at different times.

[30] Joint Press Release by the Minister of Communications and the Minister of Commerce 9 November 1994.

347. As we understand the various commentaries referred to in the NERA reports, and the various sources to which those commentaries in turn refer, the perceived advantages of ECPR are that entry will occur only when entrants have lower costs than incumbents, that it ensures that the incumbents' common costs are fully funded, and that stranded assets are avoided. On the other hand, there appear to be some five features of an ECPR-based approach which give rise, in theory, to concern as to whether an ECPR approach is compatible with the introduction of effective competition: (i) the risk of entrenching monopoly rents or inefficiencies in the retail price; (ii) the possible lack of the dynamic effect of competition, resulting from the fact that, as the Director recognises, the incumbent is indifferent as to who supplies the customer; (iii) the raising of barriers to entry; (iv) the risk of a price squeeze; and (v) difficulties in identifying the "minus" element in the retail-minus calculation. We first set out provisionally the theoretical concerns as we have so far identified, and then consider the context of the present case.

348. We note first that the ECPR is based on what would in theory occur in fully competitive conditions or in a contestable market. However, the water industry in England and Wales is not, in fact, operating in a contestable or competitive market.

349. In those circumstances, it appears to be generally accepted that unless great care is taken, an ECPR approach appears to entrench any monopoly element there may be in existing prices. This risk exists because under a retail-minus approach, the incumbent receives an access price that is, in effect, compensation from the new entrant for the business that the incumbent is losing. Thus in the example given above the incumbent is supplying a customer at £10, but if the incumbent ceased to do so it would save costs of £3. On an ECPR approach, the common carriage price charged by the incumbent to a third party is calculated at £7. It can be seen that the incumbent is financially indifferent as to whether it is the incumbent or the new entrant who supplies the customer. In either case, his net revenue is £7.

350. But if the starting point for the calculation (£10) already includes an element of monopoly rent, it seems to be accepted by the proponents of ECPR that the dominant incumbent will continue to receive the fruits of its monopoly, because the intention is that the monopolist should remain financially in the same position as it was before the

new entrant entered the market. The same is true if the monopolist is charging a high price because of inefficiency. It seems to be conceded in the NERA report that some kind of regulation is therefore essential to ensure that the retail price does not contain a monopoly profit or an element that is due to inefficiency. That in turn raises the issue of whether the regulatory system in place in the water industry as regards non-potable water to large users necessarily eliminates monopoly rents or inefficiencies so that the resulting prices can be regarded as equivalent to the prices that would occur in a competitive market.

351. A second disadvantage of ECPR, so it is said, is that it fails to achieve the dynamic effects of competition. As already pointed out, ECPR assumes that the incumbent is indifferent as to who supplies the customer, since the incumbent will receive the same revenue whether there is a new entrant or not. However, in normal competitive markets – which ECPR is intended to replicate – a supplier rarely finds itself in the privileged position of being "indifferent" to whether it loses a customer or not. The underlying assumption that the supplier will always be able to command the price that it is currently receiving does not apply where markets are competitive. Moreover, if the effect of the ECPR is simply to indemnify the incumbent, so the argument runs, the incumbent never comes under pressure to improve efficiency, give better service, reduce costs, lower prices, or innovate. Thus, so it is suggested, many of the dynamic effects of introducing competition are lost if ECPR is strictly applied.

352. Thirdly, it is said that the ECPR raises barriers to entry, and stifles the potential for price competition. The argument here, as we understand it, is that the new entrant will itself incur costs which have to be recovered, including sunk costs and common costs, and needs to earn a return on his own investment. However, under ECPR a new entrant has, in addition, to indemnify the incumbent for all the incumbent's common costs and any loss of profit which the incumbent may incur as a result of the new entry. In effect, it is said, the new entrant has to meet his own full costs, and indemnify the incumbent, out of what is, in effect, a sum equivalent to the incumbent's marginal cost.

353. Suppose for example, a new entrant A, who wishes to develop a new source of water such as a new borehole, and to use the network of an incumbent B to pipe the water to the customer. On the Director's approach A has to bear (i) the operating and capital

cost of developing the new borehole, including a rate of return on the investment, (ii) his own costs of connecting to B's system, (iii) B's costs of connection (iv) all the other costs of supplying the customer e.g customer services; and (v) all the costs which the incumbent B previously incurred in supplying the customer, including the incumbent's rate of return, less only (vi) the cost directly saved by the incumbent in no longer supplying the customer in question. The new entrant A therefore has both to earn a rate of return on his own investment but also to guarantee to his competitor B a rate of return on the latter's previous investment. These requirements, it is argued, are likely to be a formidable obstacle to new entry in many cases. Given the hurdles faced by the new entrant, the resulting scope for price competition is inevitably small or non-existent, so the argument runs.

354. Fourthly, it is said that the ECPR tends by its nature to subject potential entrants to a "price-squeeze" – i.e. to a position where the margin between (a) what the incumbent charges the new entrant for access to the system and (b) the incumbent's retail price – is insufficient for the new entrant to survive or at least compete in any effective way, even where the new entrant is as efficient as the incumbent. This issue arises directly in the present case and is further discussed in the next section of this judgment.

355. Finally, although less explored in the literature referred to in the NERA reports, there is the issue of how to determine the "minus" element in the retail-minus ECPR approach. Proponents of ECPR appear to accept that an incumbent who (i) controls an upstream facility which is essential for the delivery of a downstream product; and (ii) also supplies that downstream product in competition with a new entrant, should notionally make the same charge to its downstream "arm" as it makes to the new entrant for the upstream use of the facility in question. This is reflected in MD 163 as the requirement that:

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

356. If, however, the "minus" is calculated on the cost saved by the incumbent in supplying only one less customer, it is likely that there will be very little "minus" to subtract from the retail price, leaving little or no margin for the new entrant. Thus, when the first or second customer switches from the incumbent to the new entrant, the incumbent may

"save" very little cost. On the other hand, if the new entrant were supplying a significant proportion of the incumbent's former customers, the avoided costs of the incumbent would presumably be greater, leaving a greater "minus" to be subtracted. But at this point a kind of chicken-and-egg problem presents itself, because if there is no margin with which to supply the first one or two customers, it is difficult for the new entrant to enter the market with a small initial customer base, and then build up from there. We revert to this problem further below.

357. Those being some of the concerns about ECPR, we also recognise that it is equally of the highest importance that the infrastructure costs of the supply of water should be recovered from the generality of customers, and that new entrants should not be able to price on a "free-riding" basis whereby certain customers enjoy lower prices because they make no contribution to common costs, while the common costs are borne entirely by the generality of other customers who pay higher prices as a result. ECPR seeks to address this issue. However, the problem of access charging has, apparently, been solved in other network industries - such as telecommunications, gas and electricity – in ways which appear to have enabled the incumbent to recover common costs, while at the same time permitting effective new entry and the introduction of competitive forces.

358. Turning from theory to the present case, we comment provisionally on two aspects of the Decision, namely (a) the "retail" price used by the Director as the starting point of the ECPR calculation and, (b) the "minus" element in that calculation.

*The "retail" price used by the Director in the ECPR calculation*

359. The starting point for the Director's ECPR calculation is the price in the Second Bulk Supply Agreement of 25.8p/m³ (paragraph 331 of the Decision). That price is described as a "retail" price. However, it is not a price paid by an end consumer (which is the normal connotation of "retail"), but the price which Dŵr Cymru charges Albion for water to be resold to Shotton Paper. At present we have reservations as to whether the price under the Second Bulk Supply Agreement is correctly described as a "retail price".

360. Even if it were correct to describe the price under the Second Bulk Supply Agreement as a "retail" price, the discussion above indicates that an ECPR approach which merely entrenched the prices of an existing monopoly, or allowed the monopolist to be inefficient, would not deliver the perceived benefits of that rule. Since the ECPR is based on what, in theory, occurs in a fully contestable market, the rule appears to depend on showing that it produces the "efficient" outcome that one might expect such a market to deliver. In other words, as we understand it, the starting point for the application of ECPR should be in principle a retail price that is equivalent to a competitive price, that is to say a price approximating to the price likely to be achieved by the free play of competitive forces. Otherwise the rule simply maintains monopoly profits and/or inefficiency[31].

361. In the water industry there is no free play of competitive forces. Although the regulatory system imposes price controls in the tariff sector, by means of comparing various performance indicators between water companies and adjusting for inflation, the Consultation Paper points out that the present regime

> "lacks key features of market competition, most notably the threat of market entry and customer choice. The incentives to increase efficiency, improve the quality of service, introduce innovative practices and drive down prices may, therefore, be somewhat weaker than those provided by direct market competition." (paragraph 17)

362. In Wales, users of more than 250Ml of water per annum lie outside the system of regulatory price controls which limit prices to customers below that threshold

363. It is also the case that as regards specifically large industrial users for non-potable water, it appears that there was historically virtually no regulation of the relevant prices, which almost all derive from special agreements. Under the RAGs already mentioned, costs and revenues for non-potable water are not collected for regulatory purposes. Such regulation as there had been, in the form of the Director's approval of the New Tariff in 2003/2004, had had little practical impact on the prices being charged to large users at the time when the Decision was taken, still less when the price under the Second Bulk Supply Agreement was established in 1996.

[31] Paragraph 107 of the Telecommunications Notice also refers to the need for the competition authorities to determine what would have been a competitive price were a competitive market to exist.

364. In those circumstances it would seem to us necessary to consider whether there is evidence that the retail price used in the Director's ECPR calculation – here the price under the Second Bulk Supply Agreement – could fairly be regarded as the price equivalent to a price set at a level to be expected in a competitive market.

365. In the letter dated 12 December 1996, the Director said:

> "The price for non-potable water is similar to prices charged by Dŵr Cymru for other bulk supplies."

366. In paragraph 40 of the Decision the Director states:

> "On 12 December 1996 we provisionally decided that a price of 26p/m³ would be given to the parties as indicative of the price we would determine formally, if required to do so. In calculating this indicative figure, we had regard to the prices charged by Dŵr Cymru to an associate, Hyder Industrial, for non-potable water (an equivalent of 28.39 p/m³), the prices charged by Dŵr Cymru to six non-potable large users including Shotton itself between approximately 26 p/m³ and 29 p/m³), and Dŵr Cymru's estimated LRMC (approximately 26p/m³)."

367. Document D21 in the Reply sets out an estimate made by Dŵr Cymru, apparently in 1995/1996, in connection with the negotiations for the Second Bulk Supply Agreement. Document D21 sets out what Dŵr Cymru considered to be the cost of supplying Shotton Paper, including charges for capital items, infrastructure renewals, depreciation, rate of return, and a management "on cost" of 6.2p/m³.

368. According to its terms, Document D21 would give rise to a price under the Second Bulk Supply Agreement of some 19.6p/m³, as compared with the price in the Second Bulk Supply Agreement of 26.0p/m³. There is thus at least some evidence before the Tribunal that the price in the Second Bulk Supply Agreement was some 6p/m³ above the cost, including a return on capital, of supplying Shotton Paper, apparently calculated using averages to a large extent. That is some indication of a price above the competitive level. (In any event Albion criticises the various figures set out in Document D21 as excessive, a further issue which the Tribunal has not yet investigated).

369. Since the Director's letter of 12 December 1996, further work has been done on the costs of supplying large industrial users, resulting in the Large Industrial Tariff of

1999/2000 for potable water, and subsequently the New Tariff for non-potable users of 2003/2004. Work on the latter tariff indicates in particular that it was realised that the cost of treatment of non-potable water was some 4p/m³ less than had previously been assumed. In a competitive market, it seems to us, this would have been recognised at a much earlier stage. If the average reduction in the cost of treating non-potable water were factored into the price in the Second Bulk Supply Agreement, that would appear to reduce the latter by 4p/m³. That is a possible further indication that the price in the Second Bulk Supply Agreement may have been too high.

370. If Albion turns out to be correct that the cost of distribution, is lower for non-potable water than for potable water, as discussed above, that would also appear to raise further doubts as to whether the price under the Second Bulk Supply Agreement was a price which reflected costs.

371. As regards the comparisons with other prices paid by non-potable users referred to in the letter of 12 December 1996 and paragraph 40 of the Decision, that approach seems at first sight to suffer from a problem of circularity, since if none of the other prices approximate to the prices which would be charged in a contestable market, those other prices would not be an appropriate benchmark for an ECPR calculation, as we understand ECPR. Moreover, if those other prices did not take account of what is now accepted to be the lower costs of treatment for non-potable supplies, they would not appear to be satisfactory comparators for that reason also. If, as Albion submits, distribution costs are also lower for non-potable water, the comparisons would be further undermined. In any event, the prices in question appear to result from special agreements made many years ago and may not, at the time, have been based on costs or anything that could fairly be regarded as the free play of competitive forces.

372. With reference, more particularly, to the reliance placed on prices charged by Dŵr Cymru to Hyder Industrial (28p/m³), which is the first comparator mentioned in paragraph 40 of the Decision, Hyder Industrial is stated to have been an associate company of Dŵr Cymru. It is not at this stage entirely obvious to us that the price charged in what was apparently an "intra group" transaction would necessarily have been a good indication of what price would have been negotiated at arm's length between independent buyers and sellers in open market conditions.

373. In addition there is evidence before the Tribunal, referred to in paragraph 367 of the Decision, that Hyder Industrial was in 1997 quoting for example a price of 15p/m³ to supply a new customer (see letter of 15 May 1997). Even allowing for possible differences in the two situations (e.g. in respect of treatment costs) that figure seems significantly below the price in the Second Bulk Supply Agreement.

374. More generally, the Director tells us in his pleadings that large non-potable users pay from "approximately 15p/m³ to over 30p/m³" and that "the average" pay between 20p/m³ to 30p/m³. Obviously there is a very considerable difference between 15p/m³ and over 30p/m³ (about 100 per cent) and also between 20p/m³ and 30p/m³ (50 per cent), whereas in competitive conditions such differences in prices would tend to be eroded. It may not be easy to determine where, in competitive conditions, prices would settle. However, given the exceptionally large volumes taken by Shotton Paper one would perhaps expect that in competitive conditions Shotton Paper would be in the lower part of the range (15p/m³ to 20p/m³) rather than in the higher part of the range (25p/m³ to 30p/m³) unless for some reason the costs of serving Shotton Paper were higher than average, which has not been suggested.

375. It also emerges that the Director states that in 1996 he used prices to six other non-potable customers of Dŵr Cymru, but did not take account of lower prices to four other non-potable customers. In such cases there is some risk that the comparators selected may not be fully representative or entirely comparable. What relation any of these prices bore to the competitive level is difficult to determine.

376. Finally, as to the reference in paragraph 40 of the Decision, to the effect that the price of 26p/$m^3$ reflects Dŵr Cymru's "estimated LRMC", LRMC is not referred to in the letter of 12 December 1996 as regards non-potable water. The reference to LRMC introduces yet another method of calculating prices, in addition to the average accounting cost and ECPR methods used in the Decision. In any event, we have no evidence that would support the LRMC figure set out at paragraph 40 of the Decision, one way or the other.

377. In the light of all those considerations we have, at present, reservations as to whether the price in the Second Bulk Supply Agreement constitutes a reliable starting point for an ECPR calculation, in the particular circumstances of this case.

*The calculation of the "minus element"*

378. At paragraph 331 of the Decision the Director states that the "minus" amount to be deducted from the price under the Second Bulk Supply Agreement is 3.3p/m³, i.e. the price charged for the water which Dŵr Cymru would no longer pay United Utilities.

379. This part of the Director's calculation is thus based on local costs. Yet before the Tribunal the Director argued strongly that prices and costs in the water industry could only be determined on a regional average basis. It seems to us at first sight that there is an inconsistency here.

380. Our present view is that, under an ECPR regime, the calculations should where possible be carried out on a consistent basis. If the retail price is largely reflective of the actual cost of supplying a particular customer, including local costs, then we would have thought that the logic of ECPR dictates that the "minus" element to be deducted should also be reflective of the costs (i.e. local) costs saved by no longer supplying that customer. On the other hand, if the retail price is largely reflective of the average cost of supplying customers taking water of equivalent volumes and quality, then the "minus" element should equally be the average cost saved by not supplying customers in that category. In other words, in our view it is arguable that so far as possible, any retail price minus calculation should either be based on local costs throughout or average costs throughout, but not on a mixture of average costs and local costs.

381. A further problem with this part of the case is that the Director argues that if Dŵr Cymru were supplying Shotton Paper, the price would be set by the New Tariff, which is admittedly a retail tariff. However, the Director further argues that the New Tariff contains a calculation in which approximately 6.8p/m³ relates to resource activity (paragraph 305). Deducting that amount, says the Director, would give approximately 20p/m³, which is close to the First Access Price of 19.2p/m³.

382. The price under the New Tariff is virtually identical to the price under the Second Bulk Supply Agreement. However, if one took the former rather than the latter, on a regional average cost basis, applying what we understand to be an ECPR approach, the amount of water resource cost to be deducted as a result of Dŵr Cymru not supplying a customer on the New Tariff would apparently be the 6.8p/m³ deducted at paragraph 305 of the Decision, not the 3.3p/m ³ which has been deducted at paragraph 331 of the Decision. We are not clear how these two calculations can be reconciled.

383. In addition, the ECPR calculation in the Decision does not deduct any costs avoided other than the resource cost. We discuss this aspect under the issue of margin squeeze below.

384. There is no direct authority, as far as we know, on the compatibility of ECPR with the Chapter II prohibition, or with Community law, save for the jurisprudence on "price-squeezing" which we refer to below. The above considerations, which developed out of the hearing but have not yet been argued in this case, lead us to the view that we cannot properly decide this case without further argument on whether (a) we have correctly understood ECPR and (b) how far it was open to the Director to use ECPR to negative a possible infringement by Dŵr Cymru of the Chapter II prohibition and (c) in any event whether ECPR was appropriately applied in this case. Those issues seem to us particularly acute given the apparent conflict between ECPR and the Community case law on the margin squeeze issue discussed in the next section. It is also for consideration whether expert evidence is necessary as to the application of ECPR in this case.

## E. THE ALLEGATION OF MARGIN SQUEEZE

385. The issue of margin squeeze is closely related to the issues discussed above under ECPR.

### (1) THE RELEVANT LAW

386. In a series of well known cases, the Court of Justice has held that it may well be an abuse if an undertaking which is dominant on one market acts without objective

justification in a way which tends to monopolise a downstream, neighbouring or associated market: see, for example Case 6 and 7/73 *Commercial Solvents v Commission* [1974] ECR 223 and Case 311/84 *Télémarketing* [1988] ECPR 3261 at paragraph 27. In the context of a refusal to supply, those cases have more recently been considered in CaseC-7/97 *Oscar Bronner* [1998] ECR I-7791, which concerned the refusal of the leading newspaper publisher in Austria to allow a rival newspaper publisher access to its distribution system.

387. The effect of those decisions, in broad terms, is that it may be an abuse for an undertaking which is dominant in one (upstream) market to refuse to supply a rival with which it is in competition in a neighbouring or downstream market with goods or services which are indispensable to carrying on the rival's business, provided that (i) the refusal will eliminate all competition on the part of the person requesting goods or services (ii) the refusal is incapable of being objectively justified and (iii) the goods or services are indispensable for carrying on the rival's business, in the sense that there is no realistic possibility of creating a potential alternative: see *Oscar Bronner* at paragraphs 40 to 46 of the judgment, and the opinion of Advocate General Jacobs in that case, at paragraphs 56 to 69, cited by the Tribunal in *Burgess v OFT* [2005] CAT 25, at paragraphs 303 to 311.

388. One particular manifestation of the above general principle occurs in the case of a "price squeeze" or "margin squeeze"[32] where, instead of refusing entirely to supply the essential input in question, the dominant undertaking supplies the input to its competitors on the downstream market at a price which does not enable those competitors to compete effectively on the downstream market. The law on this issue has been reviewed recently by the Tribunal in *Genzyme v OFT* [2004] CAT 4, at paragraphs 489 to 493. In that case Genzyme supplied a pharmaceutical product, Cerezyme, to third party healthcare providers at a price which did not enable those third parties to compete effectively with Genzyme's in-house home care services, notwithstanding evidence from patients and clinicians that they wished to deal with independent home care providers, rather than with Genzyme's own in-house operation.

[32] The terms seem to be used interchangeably.

389. In its draft Guideline, *Assessment of Conduct* OFT 414a, April 2004, the OFT describes a margin squeeze in these terms:

> "6.1 A margin squeeze may occur in an industry where a vertically integrated undertaking is dominant in the supply of an important input for a downstream market in which it also operates. The vertically integrated undertaking could then harm competition by setting such a low margin between its input price (e.g. wholesale price) and the price it sets in the downstream market (e.g. retail price) that an efficient downstream competitor is forced to exit the market or is unable to compete effectively.
>
> 6.2 To test for margin squeeze, it is usual to determine whether an efficient downstream competitor would earn (at least) a normal profit when paying input prices set by the vertically integrated undertaking.
>
> 6.3 In practice, in order to determine whether an efficient downstream competitor would make a normal profit, the test is typically applied to the downstream arm of the vertically integrated undertaking. Therefore, the test asks whether, given its revenues at the time of the alleged margin squeeze, the integrated undertaking's downstream business would make (at least) a normal profit if it paid the same input price that it charged its competitors.
>
> 6.4 A test for margin squeeze might require assessing the accounts of a 'notional business' as in practice the integrated undertaking's downstream business may not have separate accounts from its upstream business and would not usually treat its input prices as a cost in the same way that an independent downstream competitor would. Therefore, the details of how costs and revenues are allocated and/or calculated will depend on the circumstances of each case. For example, a margin squeeze investigation may raise issues such as the measurement and allocation of costs and revenues (both between products and between upstream and downstream operations), the appropriate rate of return, and the appropriate time period over which to measure profitability.
>
> 6.5 If there is evidence that a vertically integrated dominant undertaking has applied a margin squeeze and that it harmed (or was likely to harm) competition, this is likely to constitute an abuse of that dominant position."

390. In the Telecommunications Notice, cited above, and which is referred to by the Director in the Decision, the Commission states in paragraphs 117 to 119:

> "117. Where the operator is dominant in the product or services market, a price squeeze could constitute an abuse. A price squeeze could be demonstrated by showing that the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company. A loss making downstream arm could be hidden if the dominant operator has allocated costs to its access operations which should properly be allocated to the downstream operations, or has otherwise improperly determined the transfer prices within the organisation…
>
> 118. In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient).
>
> 119. If either of these scenarios were to arise, competitors on the downstream market would be faced with a price squeeze which could force them out of the market."

391. In *Deutsche Telekom* OJ 2003 L263/9 the Commission's decision concerned a situation where Deutsche Telekom's charges for wholesale access to its local loop were so high that Deutsche Telekom's competitors could never sell their services to end users in competition with Deutsche Telekom, even though they were at least as efficient as Deutsche Telekom. The Commission rejected Deutsche Telekom's defence that the wholesale charges were fixed by the German regulatory authority (paragraph 104). The Commission then said at paragraphs 106 to 108:

> "106. The Commission's practice in previous decisions has been to hold that there is an abuse of a dominant position where the wholesale prices that an integrated dominant undertaking charges for services provided to its competitors on an upstream market and the prices it itself charges end-users on a downstream market are in a proportion such that competition on the wholesale or retail market is restricted.
>
> 107. In the case of the local network access at issue here, there is an abusive margin squeeze if the difference between the retail prices charged by a dominant undertaking and the wholesale prices it charges its competitors for comparable

services is negative, or insufficient to cover the product-specific costs to the dominant operator of providing its own retail services on the downstream market.

108. In such a situation, anticompetitive pressure is exerted on competitors' trading margins, which are non-existent or too narrow to enable them to compete with the established operator on retail access markets. An insufficient spread between a vertically integrated dominant operator's wholesale and retail charges constitutes anticompetitive conduct especially where other providers are excluded from competition on the downstream market even if they are at least as efficient as the established operator."

392. The Commission said at paragraphs 126 to 127:

> "126.… The margin squeeze test seeks to compare charges for two particular services at different commercial levels…
>
> The method used to determine whether there is a margin squeeze in this case is based on the principle that the established operator's tariff structure must enable competitors to compete with that operator effectively, and at least to replicate the established operator's customer pattern. It must not be assumed that the competitors' customer structure and range of services will necessarily be more profitable than those of the incumbent. The primary consideration here is the effect on market entry by competitors …"

And at paragraphs 140 and 141:

> "140. Where wholesale and retail services are comparable, as described above, a margin squeeze occurs if the spread between DT's retail and wholesale prices is either negative or at least insufficient to cover DT's own downstream costs. This would mean that DT would have been unable to offer its own retail services without incurring a loss if, during the period under investigation, i.e. since 1998, it had had to pay the wholesale access price as an internal transfer price for its own retail operations.
>
> 141. As a consequence the profit margins of competitors are squeezed, even if they are just as efficient as DT. This means that they cannot offer retail access services at a competitive price unless they find additional efficiency gains. A margin squeeze imposes on competitors additional efficiency constraints which the incumbent does not have to support in providing its own retail services."

393. The Commission concluded at paragraph 180:

> "By proving the existence of a margin squeeze, the Commission has therefore done enough to establish the existence of an abuse of a dominant market position."

(2) ANALYSIS

394. Under section 60 of the 1998 Act the Tribunal (and the Director) are required to ensure that questions arising in relation to competition within the United Kingdom are so far as possible, and having regard to any relevant differences, dealt with in a manner which is consistent with the treatment of corresponding questions in Community Law: section 60(1). Similarly the Tribunal must decide any such question in a manner consistent with any relevant decision of the Court of Justice: section 60 (2). The Tribunal must also "have regard" to any relevant decision or statement of the European Commission: section 60(3).

395. It appears to us that there is a clear potential conflict between the approach of the Commission in the Telecommunications Notice and in decisions such as *Deutsche Telekom*, on the one hand, and the ECPR approach used by the Director in the Decision on the other hand. The European Commission's approach looks at the difference between the *price* charged for the upstream input (common carriage) and the downstream retail *price* in order to determine whether an *equally efficient* competitor could compete with the dominant firm in the downstream market. If there is insufficient margin between the downstream and upstream prices, then at first sight this may constitute an abuse unless it can be justified on efficiency or other grounds. The ECPR rule, however, looks at the avoided *costs* of the dominant firm, and prescribes that entry can take place only if the entrant is *more efficient* than the dominant firm to the extent that it can fund the full cost of entry out of a margin calculated by reference to the dominant firm's avoided marginal costs.

396. Subject to further argument, at present we see difficulties in reconciling these two approaches. Unless the present case is distinguishable, section 60 would apparently require us to follow the approach of the Commission, rather than that of the Director.

397. At paragraphs 342 to 352 of the Decision, the Director refers to the Telecommunications Notice, but does not apply paragraphs 117 to 119 of that Notice. Instead, the Director argues that Albion has simply replaced Shotton Paper as "Dŵr Cymru's retail customer" (paragraph 347). Albion should in those circumstances pay a retail price equivalent to the price payable under the Second Bulk Supply Agreement, which was fixed by reference to other "retail" prices, or a price equivalent to the New Tariff which is a retail price. These two prices are virtually the same.

398. In our discussion of ECPR above, we have already indicated certain possible weaknesses in the Director's arguments based on the Second Bulk Supply Agreement and the New Tariff.

399. In particular, as regards the price in the Second Bulk Supply Agreement, in our view the concept of a "retail" price implies a price to an end consumer, whereas in the present case Albion is purchasing the water under the Second Bulk Supply Agreement for resale, not for consumption. Moreover, the common carriage arrangement that Albion proposes does not involve Albion purchasing any water from Dŵr Cymru.

400. In so far as the Director in this context relies on the New Tariff as the retail price, we have already pointed out that arguably, on an ECPR calculation, one should deduct at least 6p/m³ for the avoided cost of water resources, not the 3p/m³ the Director has in fact deducted.

401. In any event, the argument based on the New Tariff seems to us at present to be circular: since the Director resolutely maintains that the New Tariff is the "correct" retail price, he arrives at the conclusion that Albion should not be allowed a margin that might allow Shotton Paper to have a price below the New Tariff. This, however, begs the questions: (i) whether the New Tariff is reflective of the competitive price; and (ii) whether in any event, it is legitimate to arrive at the conclusion that Albion should have no margin between Dŵr Cymru's upstream and downstream prices.

402. However, as we understand paragraphs 348 to 352 of the Decision, the Director's fundamental point is that "the arrival of Albion Water has not caused Dŵr Cymru to cease to incur any retail costs", nor would Dŵr Cymru do so under Albion's proposed

arrangements (paragraphs 348 and 351). According to the Director, Dŵr Cymru is incurring the same costs as it incurred when supplying Shotton Paper directly. In the light of the case law already set out, it is not yet clear to us that this argument is open to the Director, in the light of section 60.

403. In any event, on this part of the case there is first an awkward issue of fact. At paragraph 349 of the Decision the Director contends that various "water management" and related services there referred to are distinct "value added" services which can be offered by consultants but which are not part of the "retail" activity of water supply.

404. The latter statement is contradicted by the justification Dŵr Cymru put forward in its letter of 2 December 1999 in relation to the Large Industrial Tariff for potable water which said:

> "The tariff will include the following:-
>
> Customers, using over 50Ml/annum, will be given the following benefits:-
>
> - detailed water management data
> - advice on efficient use of water and benefits of seasonal use
> - leakage monitoring
>
> Additional benefits for users over 250 Ml/annum:-
>
> - water efficiency audits"

405. Although the Director now says that such water management activities are not supplied by Dŵr Cymru beyond the preparation of generic leaflets and advice on websites, the fact remains that at the time of the approval of the Large Industrial Tariff, Dŵr Cymru put forward a range of water management services which it intended to supply as part of its retail activities and justified the Large Industrial Tariff partly on that basis. The New Tariff is in turn derived from the Large Industrial Tariff. Assuming that the Director took no objection when approving the Large Industrial Tariff, the water management services in question would appear to be properly within the scope of the tariff as far as the largest users are concerned. It would seem, arguably, to follow that these activities, now supplied by Albion and not by Dŵr Cymru, should properly be taken into account as avoided costs.

406. Secondly, as far as we can ascertain, both the proponents of ECPR and of the alternative price squeeze approach adopted by the Commission envisage that steps should be taken to establish separate "stand alone" costs for the downstream activities which the incumbent is supplying in competition with the new entrant. This is expressed in MD 163 as the principle that the incumbent

> "should charge entrants as it would charge itself and should be able to demonstrate this…"

407. The same is set out in the draft OFT Guidance 414a at paragraphs 6.3 to 6.4, at paragraph 117 of the Telecommunications Notice, and at paragraph 140 of *Deutsche Telekom*.

408. This, as far as we can see, would entail considering whether a notional downstream operation of Dŵr Cymru, supplying retail services, could acquire common carriage from a notional upstream operation of Dŵr Cymru, supplying water transport and treatment services, and re-sell the water profitably to the end customer. So framed, the answer would seem to be in the negative. Dŵr Cymru "retail" could not acquire the water from United Utilities at 3.2p/m³, pay Dŵr Cymru "transportation" 23.2p/m³ for common carriage, and resell the water profitably at 26p/m³: there would be no margin. Equally there would be no margin for a third party such as Albion to compete with Dŵr Cymru "retail". That arises irrespective of the relative efficiency of Dŵr Cymru and any such third party. On that basis, applying the Director's own Guidance in MD 163, and the Guidance issued by both the OFT and the Commission, there would at first sight be, arguably, an abuse.

409. In the first two sentences of paragraph 360 of the Decision the Director apparently accepts that MD 163 requires undertakers to charge third parties as they would charge themselves. However, the third sentence of paragraph 360 goes on to state

> "Because undertakers do not have separate businesses in this way, in practice [MD163] meant that undertakers should not set access prices for charging their competitors *that were inconsistent with their final retail tariffs, without objective justification"* (emphasis added by the Tribunal)

The Director considers that the First Access Price was calculated consistently with the New Tariff (paragraph 361).

410. Our present view is that the third sentence of paragraph 360 does not reflect MD163 or the Guidance issued by either the OFT or the Commission. First, the fact that undertakers do not have separate retail businesses, which is often the case with dominant incumbents in network industries, does not justify a failure to impute costs and revenues to a notional retail business, as required by the OFT and the Commission. The Director's apparent requirement that undertakers should charge their competitors according to the existing *retail* tariffs is in our view inconsistent with MD163, and the guidance of the OFT and Commission, which set out an entirely different idea, namely that the undertaker should charge *itself* in the same way as it would charge third parties.

411. MD 163 was still extant when the Decision was taken. In accordance with normal principles, in our view the Director should be held to his published Guidance. Similarly we see no reason why the Director should not have taken into account the Guidance of the Commission in the Telecommunications Notice, and of the OFT in 414a, as well as the *Deutsche Telekom* case, having also regard to section 60(4) of the 1998 Act. The failure to consider the costs of a notional retail arm of Dŵr Cymru would seem in our view to be an important omission in this part of the Decision.

412. The Director then advances two further arguments: (i) Albion performs no function which would legitimately entitle Albion to a margin, and (ii) Dŵr Cymru incurs the same costs in serving Albion as it did in serving Shotton Paper.

413. As to the first of these arguments, we have already drawn attention to Albion's brokerage role in our Preliminary Observations above. We have also already commented on the water management services which, according to Mr Jeffery's statement, Albion provides. In addition, Albion is a statutory undertaker under its inset appointment, which is a formal document running to over 100 pages, and which imposes on Albion the duties of a statutory water undertaker. It is evident that Albion could not carry out those duties without incurring some costs. In addition, as a retailer Albion is apparently Dŵr Cymru's second largest non-potable customer. Under its supply agreement with Shotton Paper dated 19 March 1999, Albion assumes supply obligations, the credit risk, and the functions of metering, billing, and customer service. None of these functions in our view could be carried on without at least some margin.

414. The Director however argues secondly that there is no room for any such margin because in supplying Albion instead of Shotton Paper, Dŵr Cymru does not save any costs. Dŵr Cymru still has to carry out metering and billing functions for Albion as it did for Shotton Paper. The same water is supplied through the same pipes.

415. It is true that Dŵr Cymru still has to invoice Albion as it invoiced Shotton Paper and to read meters, although in our view it does not necessarily follow that the level of activity of Dŵr Cymru's relevant customer services remains the same when Dŵr Cymru is dealing with Albion rather than Shotton Paper. Similarly, the fact that Dŵr Cymru did not apparently supply the water management services mentioned in its letter to the Director of 2 December 1998 is not in our view relevant. According to that document, those services could and should have been supplied to large users.

416. However, even on the assumption that the Director is correct that Dŵr Cymru saves very few costs in supplying Albion rather than Shotton Paper, the situation that presents itself raises in our view at least two conceptual issues.

417. The first issue is whether, if Albion is a bona fide statutory inset appointee and seeks to provide bona fide retail, brokerage and associated services, does the assumed fact that Dŵr Cymru saves few costs in supplying Albion rather than Shotton Paper, deprive Albion of the margin which the law on price squeezing would appear to require. That in turn would seem to depend in part on whether the price squeeze cases referred to above are distinguishable in this case.

418. The second conceptual issue that arises is what assumption is to be made in relation to the costs avoided by Dŵr Cymru. As already indicated above, the Director's approach in this case is to look at the local costs Dŵr Cymru avoids by no longer supplying one customer who is served by a single pipeline. On that assumption, it is perhaps inevitable that few direct costs will be saved. But if the Ashgrove pipeline served not one but 10 or 50 customers, would the analysis be different?

419. For these reasons, we do not feel able to decide this case without hearing further argument on the above points.

F. PRICE DISCRIMINATION

420. Under this heading Albion relies principally upon the difference in the prices charged to Albion and the prices charged: (i) under the Elan Valley Supply Agreement; and (ii) to Corus; and (iii) to various other companies.

421. In our view the Elan Valley Bulk Supply Agreement is distinguishable from the agreement to supply to Shotton Paper for the reasons given by the Director at paragraphs 263 to 265 of the Decision.

422. As regards Corus, it is at first sight surprising that Shotton Paper, with at least three times the volume of Corus, should apparently be paying a higher price, especially since the Director wrote to Dŵr Cymru on 28 February 2000 seeking an explanation of the lower price to Corus, and the reply to that letter, if there was one, has not been disclosed. However, as we understand it, the Corus lagoons do perform a flow balancing function, and that fact could justify some price difference. It seems to us that in the particular circumstances of this case it would be difficult to investigate further the precise cost justification for the Corus price without going into a great deal of material that was confidential as between Dŵr Cymru and Corus, and very probably giving the later an opportunity to be heard. While the Tribunal would not rule out such an investigation in an appropriate case, it seems to us that in the present case there are other more significant issues that are likely to be determinative of the outcome. In those circumstances we see no sufficient reason to doubt the Director's submissions that any price difference there may be between Albion and Corus is justified on the basis of the flow balancing function of the Corus lagoons, at least in the absence of evidence to the contrary.

423. As to the various other prices relied on by Albion, reference has already been made above to the significance of various comparators and to the quotations apparently given by Hyder Industrial. It does not seem to us appropriate to investigate these matters any further under a separate head of "price-discrimination", since they have already been sufficiently dealt with earlier in this judgment. The same is true of the issues arising under MD 163 referred to at paragraphs 359 and 360 of the Decision.

424. It follows that we do not regard it necessary to make any further findings on the question of price discrimination as a separate head of abuse, or to consider setting aside the Decision on that self-standing ground.

G. DELAY

425. The final issue is that of Dŵr Cymru's delay in quoting the First Access Price. The Director finds, at paragraphs 373 to 378 of the Decision, that the delay of approximately four months in this case, although giving rise to concern, was not sufficient to amount to an abuse, given that this was the first time that Dŵr Cymru had received a request for a common carriage price and that there was at that time no clear legal framework for responding to the request (paragraph 378). The Director, however, accepts that an unreasonable delay in such circumstances could amount to an abuse (paragraph 377).

426. We do not disagree with the Director's analysis. Each case will turn on its own facts and there may be other circumstances in which a delay of four months, or even a much shorter period could be regarded as abusive. However, the factors indicated by the Director at paragraph 378 of the Decision seem to us adequate reasons for not finding an abuse on that point in this case.

## IX CONCLUSIONS

427. This is a complex and difficult case raising important and to some extent novel issues under the Chapter II prohibition. Although the amendments introduced by the WA03 are now in force, the WA03 did not apply at the time of the Decision. In any event we have to apply the 1998 Act taking into account Community law in accordance with Section 60. However, our final judgment in this case could have wider ramifications, depending on the arguments about the construction of section 66E of the WIA91 and the relationship between the 1998 Act and the WIA91 which we have not addressed in this judgment. It is in these particular circumstances that we regard it as necessary

(a) to have further evidence, including expert evidence if not agreed, on the matters set out in paragraph 302 above as regards the estimation

and level of distribution costs of potable and non-potable water respectively;

(b) to consider whether it is necessary or practicable as a cross-check to consider the stand alone costs of the supply of non-potable water on a bottom-up basis, either in relation to non-potable users generally or the Ashgrove system in particular;

(c) to consider further the compatibility of ECPR as applied in this case with the Chapter II prohibition, having regard to the discussion in paragraphs 337 *et seq* above and the issues arising on margin squeeze also discussed above at paragraphs 394 *et seq*, including the possibility of expert evidence.

428 This matter will therefore be restored for a further directions hearing on a date to be notified.

Christopher Bellamy Antony Lewis John Pickering

Charles Dhanowa 22 December 2005
Registrar