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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1166/5/7/10

Victoria House,
Bloomsbury Place,
London WC1A 2EB

15 October 2012

Before:

VIVIEN ROSE
(Chairman)
TIM COHEN
BRIAN LANDERS

Sitting as a Tribunal in England and Wales

BETWEEN:

ALBION WATER LIMITED

Appellants

– v –

DWR CYMRU CYFYNGEDIG

Respondent

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HEARING (DAY 1)

Note: Excisions in this transcript marked “[...][C]” relate to passages excluded.

APPEARANCES

Mr Thomas Sharpe Q.C., Mr Matthew Cook and Mr Medhi Baiou (instructed by Shepherd Wedderburn LLP) appeared on behalf of the Claimant.

Mr Daniel Beard Q.C., Mr Meredith Pickford and Ms Ligia Osepciu (instructed by Hogan Lovells International LLP) appeared on behalf of the Defendant.

Monday, 15 October 2012

(10.30 am)

THE CHAIRMAN: Yes, good morning, everyone, I have a few preliminary remarks, Mr Sharpe.

First of all, many thanks to everybody for all the hard work you have put in producing the documents. Particularly thank you for the skeleton arguments, which, if I may say, having read a large number of skeleton arguments over the years, I did think that these were amongst the clearest and most helpful that I have read. So many thanks to everybody.

We have the timetable for this hearing, which we will endeavour to stick to as much as we can, and we will keep track of where we are with that as we go along.

You can take it that the members of the Tribunal have read the skeleton arguments, the pleadings and the witness statements, but not so much the supporting documents, and we are of course familiar with the judgments in the earlier proceedings, although if there are particular things that you want to remind us of in those, then you should draw those to our attention. We are going to try and stick to the glossary that we have been keeping going, last attached to the 23 April ruling, and we will be updating that as we go along, and

1 we will endeavour to stick to those tags that we have
2 attached to earlier judgments and rulings as we go
3 along.

4 We have the transcript writers with us, and of
5 course we know that you need to have a break every now
6 and then, so just let us know when you need to have
7 a rest. In any event we will probably try and have
8 a break mid-morning and mid-afternoon, time permitting.

9 Other than that, Mr Sharpe.

10 Opening submissions by MR SHARPE

11 MR SHARPE: Madam Chairman, members of the Tribunal,

12 I appear for Albion Water Limited with Mr Cook and
13 Mr Baiou. My learned friends Mr Beard, Mr Pickford and
14 Ms Osepiciu appear on behalf of Dwr Cymru. May I be
15 forgiven for referring to Dwr Cymru as Welsh Water?

16 THE CHAIRMAN: It's not really for us to forgive you, it's
17 for Mr Beard to forgive you. Why do you want to --

18 MR SHARPE: I have enormous difficulty saying it.

19 THE CHAIRMAN: As far as the Tribunal is concerned, I am
20 sure that that's fine, Mr Sharpe. As far as
21 the Tribunal is concerned, what we say or in our rulings
22 or whatever, is there any point to be made as to what
23 you should be called?

24 MR BEARD: No, the proper name is of course Dwr Cymru but if
25 Mr Sharpe wishes to refer to the entity as Welsh Water,

1 there is no difficulty with that.

2 MR SHARPE: We will deem it to be the case.

3 Well, this is the last act in a lengthy drama. That
4 drama started in late 1990s, when Shotton Paper invited
5 Albion Water to take advantage of the statutory inset
6 arrangements and replace Welsh Water as its supplier of
7 mainly non-potable water.

8 At the time Shotton was the second largest
9 Welsh Water customer, and it was fed up paying the
10 monopolist a price which it suspected and we now know to
11 have been much higher than the actual costs incurred in
12 the supply, and a much higher price than the price that
13 Corus, now Tata, was paying on the adjoining property
14 for the same product.

15 Welsh Water bought the water it needed for Shotton
16 and Corus from what was then called North West Water,
17 and I will refer to it throughout as United Utilities
18 even there will be moments when it would have been North
19 West Water, but the case can be confusing enough without
20 that.

21 It bought the water at cost, a price at the time of
22 around 3 pence per cubic metre, and even after partial
23 treatment and distribution, was making a profit of at
24 least 10 pence per cubic metre, giving it a profit of
25 roughly £700,000 maybe £800,000 a year -- I will come

1 back to the derivation of that -- on this one customer,
2 Shotton. It must have made Shotton one of the most
3 profitable customers of Welsh Water.

4 Now, in short, I will be suggesting to you that
5 Welsh Water was willing to use any means, in particular
6 abusing its dominant position, in order to prevent
7 an upstart new entry like Albion reducing those profits
8 or being in a position to develop a viable business
9 which would have allowed Albion to turn covetous eyes on
10 any more of Welsh Water's customers which might want to
11 benefit from more competitive prices.

12 Now, the plot is familiar to you. In 1996 Albion
13 sought inset appointment. Following the untested
14 submissions from Welsh Water about its costs, Ofwat
15 issued an indication of the likely price of bulk water
16 that Welsh Water should charge, and you will recall that
17 figure was 26 pence per cubic metre. Welsh Water
18 promptly reduced its current charge to Shotton at that
19 time from 27 and a bit to 26, leaving no margin for
20 Albion. Well, Welsh Water no doubt hoped that this
21 would be enough to force Albion to give up, bravely
22 Albion persisted and after eventually getting its inset
23 appointment approved in 1999 it bought its water from
24 Welsh Water and started supplying it to Shotton in 1999.
25 I will be taking you to these agreements later on.

1 Of necessity on this basis it had a zero margin, and
2 as a result it started looking for alternative supplies
3 of water, so it could undercut Welsh Water's price.
4 Since there were no other commercially viable options
5 available, Albion decided that it should take advantage
6 of the new freedom provided by the Competition Act 1998,
7 which as you well know came into force on 1 March 2000,
8 by buying water directly from United Utilities and then
9 contracting with Welsh Water for partial treatment and
10 the use of its pipeline for common carriage.

11 I will develop some of these relationships, both in
12 supply and the legal relationships later on, but I think
13 you know that of course Welsh Water itself was buying
14 the water, as I said earlier, from United Utilities, so
15 essentially Albion was seeking to cut out the middleman
16 here.

17 After much delay Welsh Water did eventually offer
18 a common carriage price, but at 23.2 pence per cubic
19 metre, the first access price, sometimes I'll refer to
20 it as the FAP. As the Tribunal recognised, since the
21 cost based price that United Utilities was charging
22 Welsh Water was around 3 pence per cubic metre, and
23 there was certainly no prospect of United supplying
24 Albion at below that cost, this meant that Albion's
25 common carriage plan was dead. I am tempted to say dead

1 in the water. Of course that was the object.

2 The Tribunal found that Welsh Water, by offering
3 a price for water which, when taken with the retail
4 price of water, constituted a margin squeeze, and in
5 doing that it had abused its dominant position, and
6 the Tribunal also found that the FAP, the offered price
7 for common carriage, bore no relationship to the costs
8 incurred or the economic value of the service offered,
9 and this was the abuse of the dominant position.

10 While Albion have benefitted from the interim orders
11 of the Tribunal, it has suffered great financial loss
12 over this long period. We are here today to recover
13 that loss. Welsh Water of course denies that Albion has
14 suffered any loss. They say that no agreement on common
15 carriage would ever have been made with Welsh Water, and
16 no acceptable deal on bulk supply would ever have been
17 struck with United Utilities, and therefore Albion
18 suffered no loss, notwithstanding the proper
19 counterfactual, which was obviously a lawful common
20 carriage price.

21 In addition to compensation, we are here also to
22 seek recognition of what we regard as Welsh Water's
23 outrageous conduct. So far they have got away scot-free
24 in relation to conduct which would normally merit
25 a substantial fine. Indeed, lesser infractions have

1 attracted heavy financial penalties in the water
2 industry. The gate is open for Albion to seek exemplary
3 damages and for the Tribunal to recognise this
4 outrageous conduct, first to punish Welsh Water and then
5 to deter it and other like-minded companies. They
6 stifle competition, especially in such an important
7 industry as water, at their peril.

8 Now, few companies would have had the determination
9 to see this process through to the final act. So this
10 is a rare opportunity for the Tribunal to send a signal
11 to dominant undertakings that payment of what is for
12 them a trivial sum in compensatory damages, even on our
13 best case, will not be the whole story, and that
14 the Tribunal is intent on awarding meaningful deterrent
15 awards in suitable cases. In this case, of course, that
16 would also further competition in the sector, both in
17 relation to Albion and to any other companies that wish
18 to put themselves in the same position as Albion and
19 create new competition for the existing regional
20 monopolists.

21 But armed with a compensatory award and armed with
22 an exemplary damages award Albion can pick up its
23 commercial ambitions where they were left off so many
24 years ago. And later I will take you to some of the
25 plans and the applications for inset appointments of

1 Albion at that time.

2 As the evidence unfolds, the plot will become very
3 apparent. It's quite sophisticated and in
4 cross-examination I'll have to take the witnesses
5 through some of the material in detail. But in the end
6 I hope and expect for you to see an obvious and
7 conscious attempt to distort competition by preventing
8 Albion offering a competitive price to Shotton through
9 common carriage. You will also see, perhaps inevitably,
10 that United Utilities would have realised that it had
11 little choice in supplying Albion with bulk non-potable
12 water at the same price as it supplied Welsh Water, if
13 only to avoid a well-founded charge of discrimination.
14 I don't need to second-guess what Ofwat would have said
15 if this had been the subject of a section 40A
16 application by Albion, or a chapter 2 complaint, which
17 of course, as the record shows, Albion contemplated at
18 the time.

19 United Utilities' own evidence reveals they were
20 acutely aware of their responsibilities under the
21 Competition Act. It's just that they wanted
22 non-discrimination by requiring Welsh Water to increase
23 what it paid United Utilities, and of course sadly for
24 United Utilities, Welsh Water didn't oblige them, so the
25 logic is obvious: Albion had to be supplied at the same

1 price irrespective of their initial posturing.

2 Now, the motive for this, and I am referring now to
3 Welsh Water's position, the preservation of
4 Welsh Water's large profits at Shotton and Corus, and
5 the need to ensure that Albion and any other potential
6 competitor knew that going after Welsh Water's business
7 would not work is, in my submission, obvious. The
8 profits were very substantial, and I'll take you later
9 to internal Welsh Water documents which show the
10 totality of the revenue which was at stake, not only in
11 relation to this application but could, in their own
12 evidence, be subject to further challenge once the
13 template had been established.

14 What did the board and management of Welsh Water
15 think? Now, I don't think it's in dispute and in any
16 event there is no doubt from the documentary record, to
17 which I'll take you, that Welsh Water was well aware of
18 the effects of the Competition Act 1998 and its
19 obligations under it. There is equally no doubt that
20 Welsh Water knew the commercial impact of what they were
21 doing. As a result of the FAP, common carriage in
22 relation to Albion was a dead letter. It's also clear
23 from the evidence which has emerged that Welsh Water
24 knew that the charge they were proposing for common
25 carriage and treatment was very much in excess of the

1 costs actually incurred in the Ashgrove System. I am
2 talking here about the actual costs incurred,
3 Heronbridge, Ashgrove and I'll take you to the internal
4 documentation later once I have dealt with the technical
5 configuration, if I can elevate the description of the
6 system.

7 Now, it's important, I think, to understand that
8 it's not necessary for Welsh Water to know to the
9 nearest tenth of a penny exactly what those costs were,
10 although, as you will see, Welsh Water had very detailed
11 accounting data in relation to the Ashgrove System, the
12 accounts and record-keeping were, I think the word is
13 granular, very granular, and you will see annual figures
14 as low as £23 identified; there are clearly obviously
15 much larger figures. These were highly detailed numbers
16 known to Welsh Water, and happily disclosed.

17 The only issue is whether Welsh water knew their
18 price was clearly in excess of those, abusive, and in my
19 submission they plainly did. How on earth could
20 Welsh Water have possibly thought they were putting
21 forward a lawful price? When you recall that the margin
22 was 26 pence, and you will recall that the FAP was
23 23.2 pence, simple maths suggest that's 80 or
24 90 per cent, leaving a trivial amount for water
25 resources, and they knew exactly what their own water

1 resource costs were, because they were paying them to
2 United Utilities, the simple maths suggested that there
3 was a trivial margin or no margin or a negative margin,
4 so they knew Albion would be out of the market. Of
5 course they knew their own costs, and the simplest point
6 of course would have been to say "Well, these are our
7 costs and the difference, that's what we will charge
8 you". But instead, as you will see -- and I am going to
9 take you to the detailed evidence and also to the
10 witnesses much more so -- they then engaged in a lengthy
11 internal process which had one object in mind, and that
12 was to move from their easily understood figures for
13 actual cost, through various accounting gymnastics, in
14 order each time, in every iteration, to raise the FAP to
15 a point when they knew that Albion would not be able to
16 compete.

17 I'll take you through, but it's perhaps done best
18 also through the evidence of the witnesses that have
19 come forward, Mr Edwards in particular, and I give him
20 early warning, we are going to have a very interesting
21 set of exchanges when I ask him to explain the
22 iterations and the intellectual gymnastics, things which
23 don't make any sense at all. We are not here talking of
24 accounting separation or accounting sophistication, we
25 are talking of simple bookkeeping.

1 Each time, we will see a new method is chosen in
2 order to increase the FAP. We move a long, long way
3 from Heronbridge and Ashgrove in order to arrive at that
4 point. We move a long, long way from non-potable water
5 to deal with potable water. We move a long, long way
6 from the costs of non-potable transmission of water,
7 which is very cheap, when in fact the basis of the
8 calculations that you will see rests upon the extremely
9 high cost of potable water with phoney estimates of what
10 it costs to treat non-potable water.

11 I am going to take you through this in due course,
12 but the record here is damning. They will see, and have
13 said, "It's all right, we were dealing with average
14 cost, average cost is what Ofwat mandated, we are only
15 doing what Ofwat told us to do, best practice". We will
16 see, in fact, what Welsh Water did, and what we will see
17 is that all of Welsh Water's calculations were based on
18 average cost of some description, even if that, as you
19 will see, properly reflected Ofwat's policy. It didn't.
20 But the average cost of providing a completely different
21 and much more expensive service, as I alluded, that is
22 to say the distribution of potable water as opposed to
23 the distribution of non-potable water.

24 In my submission, it is difficult to see how anyone
25 could ever honestly have thought it was legitimate to

1 price a non-potable service on the basis of potable
2 costs, at least without making some massive adjustments
3 and qualifications. The reality is that Welsh Water
4 went ahead with a well judged strategy, that it was
5 worth a gamble, as the odds of Ofwat successfully
6 catching them up were very long odds, especially as the
7 only information Ofwat had derived from Welsh Water.
8 And as we will see, sadly, Ofwat were pretty -- I choose
9 my words carefully here -- dilatory, in pressing
10 Welsh Water to verify the numbers they were given. It
11 can only be described as a pretty perfunctory exercise
12 on the part of Ofwat. They just believed what they were
13 told.

14 Based with that sort of odds, somebody can calculate
15 that in fact the odds of being found out were low, the
16 Competition Act regime had just started, hardly started,
17 and the prospect of a fine, if it ever crossed their
18 minds, no doubt seemed very remote. However, if they
19 were successful, an energetic new entrant would have
20 been kicked out of the market and they would have
21 protected their business from Albion or anyone else.

22 Now, it is for the Tribunal to decide to assess this
23 evidence and to come to conclusions, but if it hadn't
24 been for the Tribunal, Welsh Water would have been right
25 about not getting caught in the earlier proceedings, and

1 unless exemplary damages are imposed, they are right
2 about getting away with it, save for compensatory
3 damages.

4 Now, in opening, I plan to go through the key
5 background events which are the subject of this claim,
6 including taking the Tribunal to some of the principal
7 documents which are relevant to the issues which you
8 have to decide. In doing so, I will address a number of
9 issues relating to compensatory and exemplary damages.

10 Let me start with the background. I am well aware
11 that some of this will be very familiar to you, given
12 the reading you have kindly intimated you have done, but
13 I am also conscious that you are a differently
14 constituted tribunal to the tribunals that heard the
15 matter earlier, and that the issues that arise in the
16 present action are different from those that arose at
17 an earlier stage. So if I may be forgiven, but quickly,
18 I will take you through some of the fundamental facts.

19 We start essentially on the riverside. The
20 River Dee in Flintshire, North Wales, at a place called
21 Heronbridge, and there there is a small pumping station.
22 I believe there are four pumps -- but it's not
23 important -- which extracts water from the river but it
24 pumps the water to short way to the Ashgrove Water
25 Treatment Plant. The physical system of supply was in

1 place in 2001, and it was the same system that had been
2 in place for many years before and I understand is the
3 same system that remains in place today. United
4 Utilities owns the abstraction licence, enabling it to
5 take the water out at the Heronbridge pumping station.

6 United Utilities takes the majority of the water
7 pumped for its own use, but it has the physical capacity
8 to supply in excess of 36 megalitres a day to
9 Welsh Water's Ashgrove waterworks treatment nearby. So
10 this involves the pumping of the water along a raw water
11 main, no treatment at all, to Ashgrove.

12 THE CHAIRMAN: So it abstracts much more than the 36
13 megalitres?

14 MR SHARPE: Oh, yes, in fact multiples. The 36 megalitres,
15 which is the maximum it can extract in relation to the
16 Heronbridge Agreement, and I'll take you to that,
17 constitutes 22 per cent of the water pumped out by
18 United Utilities. My understanding is that before it
19 moves on to Ashgrove, there is one or more pipes which
20 divert the 78 per cent taken out of the Dee to United
21 Utilities which goes off as part of the United Utilities
22 network. Where it goes I haven't a clue, but my
23 understanding is that it is treated and some of it may
24 well be potable. Yes, potable water.

25 So perhaps you have a mental picture of a river,

1 pumps --

2 THE CHAIRMAN: A megalitre is a million litres?

3 MR SHARPE: Yes, it is. I am not taking any chances on any
4 technical questions.

5 THE CHAIRMAN: And that is 36 megalitres per what period?

6 MR SHARPE: Per day.

7 THE CHAIRMAN: Per day?

8 MR SHARPE: I can't imagine it either. It's an awful lot of
9 water. But papermills need an awful lot of water and so
10 do steelworks. Though as you will see later, they have
11 been using less and less.

12 MR LANDERS: Could I just ask something? You say that
13 78 per cent is United Utilities, have they got the right
14 to take more than that? Is what they abstract what they
15 need in total, including Shotton, or could they legally
16 abstract more?

17 MR SHARPE: I don't know the precise terms of the
18 Abstraction Licences which would govern the maximum they
19 can take out. I can take you to the Heronbridge
20 Agreement later.

21 Later on, not too far away, I am going to take you
22 to the Heronbridge Agreement, and it's important I think
23 to understand this, it's not obvious from the evidence,
24 for which I apologise, but thank you for your kind
25 remarks about the skeleton. The figure of 22 per cent

1 is in fact the assumption in the Heronbridge Agreement.
2 I'll take you to it later. The Heronbridge Agreement
3 based upon costs, cost allocation, it's at cost. Now,
4 I should say there is a dispute about that, and that's
5 why it doesn't think when it says at cost it means at
6 cost, what she really means is she wants a higher price
7 as opposed to covering her costs, but that's ...

8 Those costs are apportioned 22 per cent/78 per cent,
9 22 per cent for the non-United Utilities portion of what
10 is pumped out, and 78 per cent remain with United
11 Utilities, and that reflects -- and it may well be
12 a notional figure, but it represents no doubt a
13 reasonably accurate apportionment of what can go to
14 United Utilities and what can go to Corus and Shotton.

15 THE CHAIRMAN: The pumping station is owned by United
16 Utilities, and does the water have to be pumped out
17 constantly? Is it like a gas field where you can't
18 really shut it down overnight or for a day or something?
19 Does it have to keep pumping it out the whole time?

20 MR SHARPE: My understanding, unless somebody behind me or
21 beside me tells me otherwise, is that the pumps are
22 fairly old pumps and they are incapable of being
23 adjusted for volume.

24 THE CHAIRMAN: Incapable?

25 MR SHARPE: Incapable, yes, they are old pumps.

1 THE CHAIRMAN: Yes.

2 MR SHARPE: So either they have to be totally switched off,
3 which I gather doesn't happen, or the water just keeps
4 on coming out. I will explain what happens at Shotton
5 when Shotton doesn't need the water in a moment.

6 THE CHAIRMAN: Yes.

7 MR SHARPE: Now, the water that United Utilities takes,
8 which is, as you have seen, the majority of the water,
9 is pumped into what United Utilities calls its
10 integrated zone. It's a term you will come back to, but
11 it represents in fact an area covering 95 per cent of
12 the United Utilities area. You can imagine a map, so
13 with Crewe somewhere in the south, Liverpool, Birkenhead
14 to the west, and Penrith in the north. That's the body
15 broadly where the area of the integrated zone, so it's
16 pretty substantial.

17 I am instructed the evidence shows it's 95 per cent
18 of the United Utilities area. That's going to be
19 important later in cross-examination, because we do have
20 data about the marginal cost of the integrated zone.

21 Now, the water that we are concerned with is pumped
22 through a raw main -- it's just crude untreated water --
23 to the Ashgrove treatment plant. Now, this plant
24 a chemical called aluminium sulphate -- I may be wrong,
25 but this is alum, it's the mineral that the Romans used

1 as well, for what it's worth. This is added to the
2 water, which then passes through sedimentation tanks
3 called clarifiers. Now, the various solids, and I don't
4 think I need to go into too much detail here, and
5 particulates react with the alum and coagulate to form
6 a sludge blanket which then drops to the bottom of the
7 tanks. There is something called a sludge blanket in
8 each tank with each clarifier, and this acts as
9 a filter. As the water passes through each sludge
10 blanket, the solids and particulates are progressively
11 filtered out into the sludge, which is removed from time
12 to time. So you have a mental picture of tanks, alum
13 added, sedimentation falling, filtered, filtered,
14 filtered, and then, we will see in a moment, it goes off
15 to Shotton and Corus.

16 It's pretty rudimentary treatment, incredibly cheap,
17 as you can imagine, and it emerges as something called
18 partially treated non-potable water. So it's not raw
19 water as such, which means totally untreated, but it
20 is -- and you have to take my word for it, but I hope
21 it's not in contention -- a million miles away from
22 anything you would want to drink.

23 There is an issue, not an important issue but one
24 I will have to return to with the witnesses, surrounding
25 the treatment of the sludge. I apprehend you are on top

1 of that one. There was a sort of suggestion the sludge
2 was tanked away with lorries, and very expensively and
3 everything else. In fact, for most of the time we are
4 considering here, the sludge was quite simply
5 lawfully -- and I am told with no major damage to the
6 environment -- pumped back into the Dee.

7 THE CHAIRMAN: I thought for most of the time though,
8 because it was in 2002, I think they had to --

9 MR SHARPE: Well, prior to the FAP.

10 THE CHAIRMAN: Yes.

11 MR BEARD: I am sorry to interrupt. I am just concerned
12 that the issue that Mr Sharpe is canvassing there is one
13 of the matters that has been raised by Dwr Cymru in
14 correspondence as having been unpleaded vis-a-vis the
15 exemplary damages claim. This is a matter raised in
16 correspondence and I believe there was a letter copied
17 to the Tribunal on Friday in relation to these matters.
18 There are in fact three sets of issues that are of
19 concern here.

20 I don't want to stop Mr Sharpe in his flow, but
21 there is undoubtedly a legal issue in relation to these
22 points, whether or not these can properly pursued in the
23 proceedings in the light of previous Tribunal directions
24 and the absence of pleading in relation to these
25 matters. So if Mr Sharpe is floating one of those as

1 a matter which he wishes to pursue further in due
2 course, then I think it's at least right that a marker
3 is put down now. Whether or not the Tribunal wishes to
4 deal with these issues perhaps later today is perhaps
5 a matter for the Tribunal.

6 THE CHAIRMAN: Well, as I recollect it, the tankering the
7 sludge point is relevant in two respects: one as to what
8 extent costs of dealing with the sludge should be taken
9 into account when calculating the compensatory
10 damages --

11 MR BEARD: No issue there.

12 THE CHAIRMAN: -- and the second aspect of it is the 7p, or
13 the price that was raised at a meeting as the possible
14 cost and whether that was said in good faith or not.
15 It's not one that related to Ofwat, I don't think.

16 MR BEARD: I am sorry. The reason I'm cautious is because
17 if Mr Sharpe is raising it only in relation to
18 compensatory --

19 THE CHAIRMAN: Is that meeting a tripartite meeting?

20 MR BEARD: No, it was a bilateral meeting on
21 10 November 2000, and it relates only to the issue where
22 it's said that Mr Holton at that meeting misled by his
23 statements. That is an issue --

24 THE CHAIRMAN: At the moment I think we are just dealing
25 with what actually happened to the sludge.

1 MR BEARD: I am entirely content, and we deal with that in
2 relation to compensatory, but I thought it was right to
3 put down a marker.

4 THE CHAIRMAN: All right, your marker is duly put down,
5 Mr Beard.

6 MR BEARD: I am grateful.

7 THE CHAIRMAN: Yes, carry on.

8 MR SHARPE: I didn't believe that sludge would prove such
9 a contentious issue.

10 The end result after that process is that the water
11 has the particles removed from it but is otherwise
12 untreated river water.

13 From the Ashgrove Water Treatment works the
14 non-potable water can only go one way, downhill. It
15 flows with gravity down a non-potable pipeline. It
16 isn't pumped, no electricity is expended, it's free
17 force of nature. It's a characteristic of this case
18 that we can't even reach agreement as to the exact
19 length of the pipeline. It could be 15 kilometres,
20 I have seen estimates of 19, 21 as the crow flies,
21 I don't think it matters tuppence, but either way it is
22 not a particularly long pipeline in water industry
23 terms, and I am happy to settle for 15 kilometres.

24 Now, at the end of this gravity fed non-potable
25 pipeline, there are only two end users for the water,

1 Shotton Paper, Corus, now Tata.

2 I am going to keep on calling it Corus because
3 that's what we see in the documents too.

4 Before it reaches the site, the pipeline divides at
5 what's called a rotork valve. That controls the supply
6 to Shotton Paper and Corus.

7 Now, Shotton's demand varies over time with the
8 needs of the production process, and when demand is
9 lower, the water coming down the pipeline is diverted to
10 Corus, which has the benefit of some lagoons where the
11 water can be stored.

12 THE CHAIRMAN: Did you say the demand varies over the time,
13 what, in the course of a day or over years?

14 MR SHARPE: My understanding is that the production process
15 for Shotton Paper does vary over a day: it's variable,
16 that's what I have been told. There is a point which we
17 will come to later that, over the years, Shotton's
18 demand has actually fallen, as has of course Corus.

19 The simple description is essentially a rotork pipe
20 and what Shotton doesn't need is then moved
21 automatically to Corus. It is then stored in tanks
22 whether Corus needs it or not.

23 My understanding is the whole system works remotely
24 using telemetry, and the Ashgrove System itself is
25 unmanned. So it's a very simple system, if somewhat

1 antiquated. The non-potable system from Ashgrove is not
2 connected to the rest of Welsh Water's network, and has
3 very limited assets. That's the raw main, the Ashgrove
4 Water Treatment works and the non-potable gravity main.

5 Each of these assets is separately identified and
6 accounted for in Welsh Water's records. It's worth
7 noting at this point that Welsh Water had a number of
8 other customers for non-potable water, but only three
9 customers to which it supplied the same product, namely
10 partially treated non-potable water. My understanding
11 is the evidence shows that all the other customers
12 received raw water and processed it themselves or dealt
13 with raw water. Those three customers of non-potable
14 water were Shotton Paper, Corus at Shotton, and the
15 other Corus steelworks at Llanwern. All the other
16 customers received completely untreated raw water. This
17 made Shotton Paper part of a class of only three
18 industrial customers for partially treated non-potable
19 water.

20 In terms of the commercial relationships at
21 Ashgrove, the first relationship which is important for
22 our purpose is the contractual relationship between
23 Welsh Water and United Utilities. Now, may I take you
24 to bundle 2, tab 2.

25 This is known as the Heronbridge Agreement. There

1 is some lesser mystery about this, let me just offer
2 a quick explanation. This agreement or rather the
3 supply arrangements had been in force for some
4 considerable time before 1994, and this agreement dated
5 10 May 1994 reflects that earlier arrangement.

6 Somewhere in the bundle you will see references to
7 another agreement dated 1996, but I don't know what it
8 was doing there, I don't know whether it was a mistake,
9 it's not in the bundle, the 1996 arrangements, and both
10 parties have proceeded on the basis of 1994. If it's
11 good enough for Mr Beard, I think it's good enough for
12 me in this respect.

13 If we pick it up at clause 7, page 104 of the bundle
14 deals with various aspects about maintenance. 7(b) is
15 important, this deals with the maximum quantity of
16 supply, the maximum quantity would be 36 megalitres per
17 day or such alternative or greater or lesser amount as
18 the parties may agree in writing from time to time. So
19 we see that.

20 If we now turn to clause 9, perhaps noting that it's
21 up to 36 megalitres, the maximum quantity, 9 deals with
22 Welsh Water contributing to any capital expenditure at
23 Heronbridge to the extent that it is of benefit to the
24 Ashgrove supply.

25 Over the page, you see some reference at (b) to the

1 provision for future efficiency improvements. You will
2 see a reference to, six lines down in (b):

3 "The variable speed pumps and their possible
4 installation."

5 I think I said earlier these pumps just pump the
6 water out and were incapable of being controlled, the
7 flow couldn't be controlled at Heronbridge. They could
8 be switched off, but here we are talking about variable
9 speed pumps which enable some calibration. My
10 understanding is it's hardly important that that
11 investment has not been made.

12 You will also see a reference:

13 "In the event that DCC require quantities in excess
14 of 36 megalitres per day then a fourth pump [I misspoke,
15 there are three pumps] may be installed providing the
16 ultimate capacity does not exceed 50 megalitres."

17 If we go over the page to clause 11, the agreement
18 provides for United Utilities to determine each year the
19 actual cost attributable to Heronbridge intake works.
20 So 11(a), if you would kindly read it.

21 (Pause)

22 You will note it refers to "in respect of capital
23 financing charges, fixed operational costs and
24 overheads", providing of course the maximum offtake
25 isn't increased from 36 upwards.

1 You will see there the figure, "will pay 22 per cent
2 of such costs".

3 That 22 per cent being the proportion of
4 Heronbridge's capacity designed to go through Ashgrove.
5 It's not just for costs, it's also the cost of
6 abstraction licences, you will see that at 11(b):

7 "Extraction charges levied now by the Environment
8 Agency."

9 You will see how this works, there is an entitlement
10 to up to 36 megalitres, unless adjusted up to 50 by
11 agreement. There was the cost sharing arrangement. The
12 costs aren't just simple operational costs, they are
13 financing and other costs, and the costs are then
14 apportioned. But the costs don't vary -- with one
15 exception I'll come on to -- with the amount actually
16 taken. These are essentially fixed costs. So if the
17 full entitlement of up to 36 megalitres is taken, then
18 the average cost per megalitre would fall, but obviously
19 if a lower quantity were taken, the average cost per
20 litre, calculated ex post, would increase. So it's
21 rather like a take or pay contract.

22 MR COWAN: I just wonder in 11(a) whether anything turns on
23 the fact that it doesn't say that, it doesn't say "up
24 to", it says the proviso is:

25 "Whilst the supply under 7(b) above

1 manner in which the contract has been operated. As we
2 will see later in the evidence, well, certainly nothing
3 in the period with which we are concerned has got them
4 anywhere near 36 of the total requirements. You will
5 see arrangements, the contemporary documents about 2000,
6 2001, referring to a total of 26 megalitres average per
7 day, and that figure I think has fallen subsequently.

8 MR LANDERS: So their obligation is to pay for 36, whether
9 or not they use it?

10 MR SHARPE: Yes. That's why I think I am entitled to call
11 this a take or pay contract.

12 It's a point of some significance in the light of
13 what's emerged from my friends' skeleton. I am not
14 going to make an easy point, but it now seems that it is
15 Welsh Water's case that they would continue to assert
16 not only rights -- well, they would assert their right
17 to take up to 36 megalitres, even if common carriage had
18 been granted to Albion.

19 THE CHAIRMAN: Yes. That was one of the points I was
20 trying, I think, to get to the bottom of. Is it correct
21 or do you accept it is correct to say that they have
22 a right to have 36?

23 MR SHARPE: Up to 36.

24 THE CHAIRMAN: Up to 36?

25 MR SHARPE: Yes.

1 THE CHAIRMAN: So in answer to the point that Mr Cowan was
2 making as to how you interpret 11(a), although it says
3 "Whilst the supply remains at 36 megalitres" --

4 MR COWAN: You then have to pay 22.

5 THE CHAIRMAN: But you are saying you have to pay the
6 22 per cent for as long as the maximum supply is as it
7 is stated to be in 7(b), even if you don't actually take
8 the 36 megalitres, that's how it's been interpreted?

9 MR SHARPE: That's how we interpret it and actually how it's
10 operated, much more importantly. I said earlier that to
11 our knowledge they have never taken anything like
12 36 megalitres, they have always taken significantly
13 less, their offtake, I understand it, has been falling,
14 yet they have had to pay 22 per cent of the fixed costs.

15 THE CHAIRMAN: But they have not renegotiated the maximum
16 figure in 7(b), then?

17 MR SHARPE: My understanding is never not, and it's
18 understandable because there has been no demand for it.
19 The true characterisation of this is you have Shotton
20 with two customers and there is nothing else.

21 As the evidence will show, and I will take you and
22 the witnesses to it later, this is an area of very
23 significant water surplus. So neither these customers
24 need the water at all. You will also see evidence, and
25 I'll take you to this in my opening and I will also take

1 Ms White to it, I give her some advance warning of that,
2 she is with us, they are on record as saying there was
3 a water surplus, their own documentation refers to
4 a water surplus.

5 But there is one exception, and that's found in
6 11(c). The truly variable cost in all of this is the
7 electricity. Electricity is required to pump the water
8 from the river to Ashgrove, and if the water is not
9 taken, then the electricity cost is deemed not to be
10 attributable to Welsh Water. So the electricity cost,
11 unlike water, is based upon Welsh Water's actual
12 consumption. My understanding, if you want to get
13 a feel for the relative importance of electricity, that
14 in 2000, 2001, the electricity component is something of
15 the order of 7 pence per cubic metre.

16 THE CHAIRMAN: Out of the 3 pence?

17 MR SHARPE: Yes, about 3.

18 MR LANDERS: Can we be clear where that 3 comes from, is
19 that the average based on 36 or is based on the actual
20 usage?

21 MR SHARPE: No. Sorry, it is the average having regard to
22 the water they actually took. So the fixed element is
23 the 22 per cent which remains unchanged. But if we want
24 to get a meaningful number for what it actually cost
25 them per litre, that's the figure divided by, I think,

1 26, 22, 26 megalitres a day. So in answer to your
2 question, it's not 36. That of course would be an even
3 lower figure.

4 Now, the other point about the agreement to draw
5 attention to, you won't find any price escalation figure
6 in the contract, and I think you know that price
7 escalation is an issue between the parties, and the
8 reason for that I think is simple: here the price is
9 based upon actual cost. If the costs don't move, there
10 is no need to index them, whereas if the costs do move,
11 you either take the actual cost or, as we will see in
12 other agreements, you relate them to a publicly
13 available index. In case there is any doubt as to what
14 I meant, and I understand there is, here we are
15 concerned only with actual costs, whether they go up or
16 down, there is no necessity to index those costs because
17 we are based only on actual costs.

18 THE CHAIRMAN: How often do they recalculate that, every
19 financial year, I see?

20 MR SHARPE: Yes.

21 THE CHAIRMAN: I see.

22 MR SHARPE: It's an annual adjustment. The contract itself,
23 as you will see from clause 17, is of indefinite
24 duration. If you look at 17, you will see:

25 "The agreement will be deemed to have commenced on

1 1 July 1996."

2 I alluded earlier to the fact that this really puts
3 in formal form the arrangement that had existed earlier.
4 It just goes on until the parties agree to terminate it.
5 You see?

6 THE CHAIRMAN: Yes.

7 MR SHARPE: Jumping ahead slightly, and I'll take you to it
8 in due course, but section 40A of the Water Act, as
9 I think you know, provides a statutory machinery for
10 Ofwat to look at various existing agreements, and if
11 they consider it expedient and in accordance with
12 economic efficiency and having regard to the matters set
13 out in section 40A, there is provision for Ofwat to
14 terminate agreements and to vary them.

15 THE CHAIRMAN: When was that inserted in the
16 Water Industry Act?

17 MR SHARPE: Can I come back to you?

18 THE CHAIRMAN: Yes.

19 MR SHARPE: It's bundle 14, and I think it was in existence
20 at this time. Yes, it wasn't inserted, it was part --
21 no, 40 deals with entry making agreements, the parties
22 have no agreement, and they can go to Ofwat to formulate
23 the terms of an agreement between the parties. 40A
24 provides for the amendment of an existing agreement.

25 THE CHAIRMAN: Is it (a), it's not 40A as in the --

1 MR SHARPE: No, 40A.

2 THE CHAIRMAN: So it must have been inserted by some --

3 MR SHARPE: Yes.

4 THE CHAIRMAN: In due course perhaps let us know.

5 MR SHARPE: So if one is looking for a means by which this
6 contract could be terminated, it's section 40A. And if
7 you are looking for a means by which its terms can be
8 amended, and this is important in the light of what
9 United Utilities attempted to do, we will take you to
10 that, it's section 40A. So it's a statutory machinery.

11 Lastly, if I can take you to schedule 3 of the same
12 agreement -- perhaps I can hit the point we discussed
13 a moment ago. My learned junior's researches tell me
14 that section 40A was at least in existence on
15 1 April 1996.

16 MR BEARD: If it assists, it was inserted by the Competition
17 and Service (Utilities) Act.

18 THE CHAIRMAN: What year was that?

19 MR BEARD: 1992.

20 MR SHARPE: Yes. As can be seen from footnote 1 to the
21 extract we had in the Act. So I am much obliged to my
22 friend. By the way it was in existence at all relevant
23 times. Thank you.

24 Then if we go to schedule 3, page 117, we see why
25 the costs were set out. It's by no means clear, and

1 I think nothing hangs on it. But you see provision of
2 the financing charges, abstraction charges, operating
3 costs, power estimate based upon the earlier, and then
4 at the end of it a figure is arrived at.

5 I have no wish to detain you with this, partly
6 because it is in fact a merely illustrative calculation,
7 but it gives you an idea of how they would have
8 calculated the costs, and I am not relying on the actual
9 numbers, just the manner in which they arrived at them.

10 But it is fairly detailed in that sense. We can see
11 it includes financing charges. Can I add here: by
12 financing charges, we think offering a reasonable rate
13 of return on the assets in place. Then of course the
14 obvious costs, abstraction costs, operating costs at
15 Heronbridge, and electricity.

16 Now, we can put bundle 2 away.

17 THE CHAIRMAN: If you are moving to another topic, can I ask
18 whether the transcribers would like a break?

19 MR BEARD: Just one matter to pick up before the Tribunal
20 rises, the question was raised about the total
21 abstraction licence numbers. Just for reference, in
22 bundle 5, document 227, at page 1450 and 1451, there is
23 a detailed description of the abstraction licences at
24 paragraphs 55 through to 57. It's an Ofwat document,
25 and it sets out the Heronbridge abstraction licence

1 amount, but also the interrelationship with other
2 abstraction licence arrangements on the River Dee, just
3 for the Tribunal's reference. I am not sure anything
4 turns on it.

5 MR SHARPE: Not in these proceedings, but maybe elsewhere.
6 If that is a convenient moment?

7 THE CHAIRMAN: Yes. How are we getting along timing wise,
8 Mr Sharpe?

9 MR SHARPE: I am somewhere between about a fifth and
10 a quarter of my way through.

11 THE CHAIRMAN: We had better take a short break, then. We
12 will just take a break for five minutes and come back at
13 20 to 12.

14 (11.35 am)

15 (A short break)

16 (11.40 am)

17 THE CHAIRMAN: Yes.

18 MR SHARPE: You might need bundle 2 in a moment. I have
19 been instructed that the question of flow and valve has
20 added complexity, the full relevance of which escapes
21 me. The best way to deal with the complexity might be
22 in my evidence, Dr Bryan's evidence-in-chief, it
23 will occupy us for 15 seconds but I want you to have
24 an accurate picture. The salient feature is that
25 Welsh Water takes what it needs and no more, but pays,

1 by reference to the fixed costs, up to 36 megalitres
2 minus 0.7 for electricity.

3 Now, as you have seen from this, Welsh Water, what
4 it paid was based upon actual costs. Now, I don't
5 intend to take you to it, but I simply refer you to
6 Ms White's evidence that United Utilities wanted to
7 increase the price paid by Welsh Water because it was in
8 her words, and I am quoting now, "a non-cost reflective
9 price". Let me give you the reference, and we will come
10 back to it later, and I shall certainly come back to it
11 with her. That is White 1, which is at bundle 1, tab 1,
12 page 7 at paragraph 20.

13 So that's what she says. Just to hit the point
14 further, I will take you now to tab 28 of bundle 2 at
15 page 399. I am not going to detain you long on this,
16 but this is an internal United Utilities document dated
17 2 September, and I believe it to be 1999, from
18 Tina Boulton, business, sales and marketing. This is
19 a report by her. It's her description, and it's just
20 a very simple point. Look at the background, it talks
21 about historical agreement, established since
22 privatisation, under paragraph 3, "Background":

23 "Under this agreement North West is obliged to
24 supply at cost."

25 So this was an internal document, whatever Ms White

1 may be saying now in 2012, her colleagues in 1999,
2 incidentally before she came on the scene, were to say
3 exactly as I have just submitted, and as is indeed
4 obvious from the schedule, they were being supplied at
5 cost including the financing cost. Just to sort of take
6 the point even further home, if I can ask you to go to
7 bundle 4, tab 153, it says exactly the same thing. This
8 is the sales strategy group within United Utilities,
9 it's a report by Mr Lees, whose name will figure in some
10 of the other messages going to and fro. It's devoted to
11 Heronbridge. He has exactly the same. See at the end
12 of the first paragraph:

13 "UU was obliged to supply DC at cost, around 3 pence
14 per cubic metre depending on volume."

15 The short point is they were supplied at cost and
16 the cost included all elements of cost, including
17 financing and including a rate of return.

18 THE CHAIRMAN: Yes, bearing in mind that there were separate
19 provisions in the Heronbridge Agreement for paying for
20 either a additional pump, if they needed more than 36 megalitres,
21 or when the time came to improve or update or replace
22 the existing pump. So there was nothing built into that
23 cost schedule, schedule 3, that provided for future
24 replacement cost, because that was dealt with
25 separately.

1 MR SHARPE: And the body of the agreement, as you rightly
2 say, respectfully, allocates responsibility for those
3 extra capital expenditure.

4 While I am dwelling you on this and taking you to
5 one or two lines in the bundles, because Ms White
6 disagrees, it's not cost reflective, and she is using
7 that to indicating that the figure of 3p per megalitre
8 constitutes in some sense an artificial or improper
9 figure to base any agreement ultimately with Albion.

10 It's not cost reflective, it's inappropriate, it's
11 inefficient, you will see some of this in her own
12 language later on, and in some sense you, the Tribunal,
13 should disregard that figure as being somehow artificial
14 and inappropriate as a benchmark figure, and by
15 implication Dr Bryan was totally misguided, misled
16 himself into thinking that it was a reasonable
17 aspiration for him to achieve. We will deal with that
18 heavily in evidence, and I will also show you what Ofwat
19 thought about that argument in due course.

20 As you will see, United Utilities was being paid the
21 actual cost, and then made really quite strong efforts
22 to increase the price paid by Welsh Water, including
23 unsuccessfully referring this agreement, the Heronbridge
24 agreement, to Ofwat, to exercise its powers under
25 section 40A. He gives reasonable, and I will be putting

1 this to Ms White, there is no-one else I can put it to,
2 that United Utilities saw how much money Welsh Water was
3 making out of Shotton and Corus, out of their water, and
4 didn't want to be excluded. Who can blame them? They
5 were selling water at cost in a very low cost facility
6 and yet who was benefitting from that? Well,
7 Welsh Water.

8 We will see later, in fact I'll refer to it in view
9 of the time, they consulted -- United Utilities retained
10 Oxera, the economic consultants, to explore various
11 strategies to sort of navigate their way around this
12 problem, including, for example, United Utilities
13 seeking common carriage itself from Welsh Water, so it
14 could transport its own water through Welsh Water's
15 common carriage arrangements.

16 I'll give you the reference, it's at bundle 2,
17 tab 26, but I am not going to take you there.

18 A further point to note is that while Welsh Water
19 had a contractual entitlement of up to 36 megalitres
20 a day, other than by agreement, agreement it could only
21 use that water at Shotton Paper and at Corus. The
22 position would change if another industrial customer
23 moved into the area, but there is not the slightest
24 evidence that was ever contemplated by anyone, not in
25 the evidence. And for what it's worth, it hasn't

1 happened since then. In other words, it had no other
2 use for the water. We will see United Utilities saying
3 it placed no value on the water because there was
4 a superabundance of water, and but for these two
5 customers, Welsh Water wouldn't have needed the water.

6 You saw, and you will see further, that Welsh Water
7 at no time used anything near to its entitlement of
8 36 megalitres a day. You will see in the evidence that
9 Shotton was taking around 20 megalitres a day, and Corus
10 I think at its most was up to 6 megalitres a day, giving
11 a substantial and unused surplus.

12 THE CHAIRMAN: Which is just not then abstracted from the
13 river?

14 MR SHARPE: Yes, by inference. It could have been
15 abstracted and sent off around United Utilities as part
16 of -- if they needed it, but we have no evidence to that
17 effect. It's unlikely, though Dr Bryan will assist us
18 later in evidence, they didn't have the capacity to do
19 that.

20 To forestall my questions to Dr Bryan in
21 evidence-in-chief, there is in fact a valve. The pumps
22 themselves are non variable, they just keep on pumping,
23 but there is a valve which can be, like a tap, turned
24 around so it's half full and half on, which can slow the
25 flow to Shotton, and the lagoons assist if there is any

1 overflow, but of course there is an awful lot of water
2 in 15 kilometres of pipe as well. So the position is
3 slightly complex, but again the short point is that
4 these customers have never taken anything like the
5 entitlement that Welsh Water had negotiated and agreed
6 in the Heronbridge Agreement.

7 Now, prior to the arrival on the scene of Albion,
8 there were two other commercial relationships with
9 Ashgrove System and you know them: one is Shotton Paper,
10 the other one is Corus. Both of these arrangements were
11 what were called special agreements, that is to say they
12 were bespoke agreements, including bespoke prices, since
13 at the time Welsh Water didn't have any standard prices
14 for large scale industrial non-potable users.

15 Welsh Water's agreement with Shotton Paper required
16 it to pay 27.4 pence per megalitre, while Welsh Water's
17 agreement with Corus only required it to pay around
18 14.4 pence -- Corus to pay 14.4p per metre cubed. So
19 sorry. I can't read my writing. 27.4 per cubic metre,
20 paid by Shotton, 14.4p per cubic metre paid by Corus.

21 So you can understand Shotton was paying pretty well
22 twice as much as Corus, and it is fair to note that
23 British Steel's price had originally been fixed under
24 a longer term agreement, but that agreement expired in
25 1996, but Welsh Water then voluntarily carried on

1 charging British Steel the same price -- Corus.

2 So they were charging two customers exactly the
3 same, non-potable water, Corus in fact had lower
4 volumes, if that matters, and using the same system,
5 over the same length for the same treatment, but wildly
6 different prices. You might ask: how on earth did that
7 situation arise? The simple answer is: at that time
8 there was no effective regulation, either under the
9 water legislation but in particular under the
10 competition legislation of non-potable water for large
11 industrial customers.

12 Perhaps most importantly, prior to Albion's entry
13 initiative, there was no competition anywhere in England
14 and Wales in relation to such supplies with the result
15 that the customer simply had to accept whatever price
16 the local monopolies chose to impose.

17 Now, while Shotton Paper do not appear to have known
18 exactly how low a price British Steel was being charged,
19 they obviously had a fair idea that they were being
20 charged much more than British Steel, and overcharged on
21 the basis of simple arithmetic, if we take Shotton
22 Paper's volume times the difference in price, 27/14, it
23 amounts to somewhere in the order of £800,000.

24 They didn't know that, but Welsh Water knew it, and
25 that's the figure that was essentially in contention if,

1 and we will see, as Albion sought, to equalise the
2 prices between Shotton Paper and Corus.

3 Now, of course Albion attempted to do that, but
4 Shotton had also attempted to renegotiate its prices
5 with Welsh Water and it failed, and that's when it
6 turned to what was then called Enviro-Logic Limited,
7 that's Albion, as it was known then, to apply for
8 an inset appointment.

9 So we have the sequence of events which is the
10 customer going to Albion and saying "We think we are
11 paying too much, come in and act as a competitor and do
12 your best". They thought that Albion would be in
13 a better position than Shotton to negotiate a better
14 price, and they would have been right.

15 Shotton would also have had the benefit of added
16 value services. Throughout this whole case over the
17 last ten years it's been attempted to minimise and
18 diminish what Albion actually does, it simply buys the
19 water and resells it. It doesn't, the evidence shows
20 that it puts people into the plant and encourages water
21 efficiency, it adds value.

22 A moment's reflection, if you are selling at your
23 retail of what you are buying at wholesale prices, no
24 margin, the only money that Albion could make was the --
25 well, it could then only go on and achieve water

1 savings, which was valued by Shotton.

2 Anyway, Albion applied for the inset appointment in
3 February 1996, it applied to Ofwat to determine the
4 appropriate terms of a bulk supply agreement in
5 parallel.

6 So Albion was challenging Welsh Water's monopoly in
7 the area, and seeking to take the custom of what was its
8 second largest customer and an extremely profitable one.

9 Here I want to take you to bundle 4 at tab 155.
10 This is the document that has come to be known as D21.
11 This is based upon an internal Welsh Water document that
12 was produced in 1996, and it was produced in response to
13 Albion's inset application. But it was not disclosed to
14 either Ofwat or Albion in 1996, it was only provided to
15 Ofwat in 2001 in response to a demand under section 26
16 by Ofwat for relevant papers. I think it was seen by
17 Albion only in the context of Tribunal proceedings in
18 October 2004. What's significant about this document,
19 it is the only attempt by Welsh Water which still exists
20 to calculate the actual costs of the supply to Shotton
21 Paper. I say "Still exists" because while there are
22 a number of references in 2000 to local cost exercises
23 being conducted by various Welsh Water staff, none of
24 the product of that work has been disclosed and
25 presumably no longer exists. It seems from Mr Jones'

1 statement -- Mr Jones was and I think still is the
2 finance director of Welsh Water, in 2006 that none of
3 the contemporaneous documents supporting the 1996
4 calculations, this document, existed in 2001. So they
5 had disappeared before then.

6 I am going to give you the reference to Mr Jones but
7 I am not going to take you to it: bundle 6, tab 241,
8 1923 at paragraph 20.

9 What's interesting about D21 is that Welsh Water
10 calculated a cost of the full supply, including a return
11 on capital employed, and including the supply of water
12 itself, and it arrives at a number which you will see
13 over the page, second page, 969, of 19.56p per cubic
14 metre. If you take off 3p for water resources,
15 thereabouts, what they were paying United Utilities, you
16 have an implied common carriage element of about 16p per
17 cubic metre. It's perhaps intriguing and no doubt
18 coincidental, that's not very far away from the final
19 outcome of the Tribunal's proceedings in 2008.

20 However, even that figure was only reached by
21 inflating a number of cost elements. Dr Bryan explains
22 this in his witness statement at paragraphs 217 to 221.
23 I am reluctant in view of the time to take you to that,
24 and you have indicated you have read it, but for your
25 note paragraphs 217 to 221.

1 For present purposes, let me draw your attention to
2 one category, which is the management on-cost, which you
3 will see at page 969, it's on the second page of the
4 document, do you see?

5 "The management on-costs, pence per cubic metre of
6 6.2p."

7 Do you see it?

8 THE CHAIRMAN: Yes.

9 MR SHARPE: Now, the price of water without the management
10 on-cost would be 13.3, so the management on-cost adds
11 pretty well 50 per cent to the cost. Now, to put that
12 in context, over the entire volume of Shotton Paper's
13 supply, that management on-cost amounted to over
14 £400,000, and if we take into account Corus's demand, it
15 suggests that the management on-cost for the
16 Ashgrove System was around £600,000.

17 Now, at no point in the past Tribunal proceedings
18 did Welsh Water ever put forward any category of costs,
19 let alone any justifiable category of cost, of
20 a management on-cost of anything like this size.

21 When we turn to Mr Jones' second statement -- and
22 again if I may I will give you the reference,
23 bundle 6/241, page 1926 at paragraph 28 -- he records
24 a figure for management on-costs of 1.1p per cubic
25 metre.

1 Now, in other words, what he was answering to there
2 constituted something in the order of one-sixth of what
3 costs Welsh Water had declared internally, but perhaps
4 more importantly what costs they gave to Ofwat in 2001,
5 a massive inflation, six times the amount that he, the
6 finance director, answered to in 2006 in his witness
7 statement. The earlier number, if I can be blunt, was
8 pure fiction. It is noticeable that Welsh Water has not
9 since attempted to defend it.

10 Now, the management on-cost figure looming as large
11 as it did, hiking the price 50 per cent, was therefore
12 simply fantasy, and I thought Welsh Water must have
13 known that it was fantasy. However, it served its
14 purpose in 2001 when it was provided to Ofwat, it
15 allowed Welsh Water to put forward a local cost figure
16 which was reasonably consistent with the price that
17 Welsh Water wanted to advance.

18 Now, if we take a more realistic management on-cost
19 figure, taken from the Tribunal proceedings earlier, if
20 we take it as 1.1 per cent --

21 THE CHAIRMAN: Pence.

22 MR SHARPE: Pence, the bulk supply based on the 1996 figures
23 would have been less than 15p per cubic metre, that is
24 to say consistent with the price that Welsh Water was
25 charging Corus at the time, and that amounted to

1 a common carriage price of about 11.5p per cubic metre.

2 Now, just to repeat, that shows the scale of profits
3 that Welsh Water was making from Shotton Paper, and it
4 shows the profits which were under threat from Albion,
5 and it's the barest minimum because if Albion were
6 successful with Shotton Paper, it might have been
7 successful with Corus, and moreover it might have been
8 successful with Welsh Water's other clients, customers.

9 Now, while it took a number of years for a proper
10 common carriage price to be determined in the
11 proceedings first before Ofwat and then before
12 the Tribunal, as the operator of the system, Welsh Water
13 had since 1996 a very clear idea of the actual costs
14 involved and therefore what a cost reflective price
15 would have been, but for various reasons chose not to
16 share this information until it was forced to. And when
17 it did share the information, first with Ofwat and then
18 under disclosure, it produced numbers which were pure
19 fiction.

20 Now, D21 was not provided in 1996, but even then,
21 with all the inflated figures -- and I have referred
22 earlier, you will recall, to management on-cost but
23 Dr Bryan refers to other examples in his witness
24 statement -- it still only came to 19.5p per cubic
25 metre, a figure which was not high enough to protect

1 Welsh Water's existing profits, based as they were on
2 a supply price to Shotton at that time of 27.4p per
3 cubic metre.

4 Now, instead, what Welsh Water did was simply to
5 tell Ofwat that it had calculated the costs of the local
6 system as being 23p per cubic metre, and we find this at
7 bundle 2, tab 7. This is a letter from Welsh Water to
8 Ofwat, dated 23 July 1996. I want to take you to the
9 second page, 178, it begins:

10 "Comparison with Ashgrove costs".

11 It's notable here, first of all, there is no
12 reference at all to the internal work that had been
13 done, the D21 document, or indeed anything else, that
14 produced a much lower, albeit inflated figure, so with
15 the benefit of disclosure it seems that Welsh Water gave
16 Ofwat a false figure, or at least a different figure
17 from the contemporaneous figure they had generated for
18 the same purpose.

19 Over the page we see the figure of 23p. So this is
20 them telling Ofwat they have calculated -- I say it
21 can't be done precisely, but the cost of the current
22 system is calculated at 23p per cubic metre. Where they
23 get that figure from, I don't know. It bears no
24 relationship to D21, and is somewhat higher than the
25 figure that was proposed. Of course it had to be

1 higher, because at 19p or so in D21 there would have
2 been a margin to undercut them.

3 Now, Welsh Water attempt to minimise the importance
4 of D21, it was an old document, it was a hybrid and so
5 forth. Respectfully, you will have to make up your
6 minds about that. It is the only document we have seen,
7 it was good enough to give to Ofwat, the qualifications
8 appear subsequently down the line in Tribunal
9 proceedings, and the letter itself, shall we say, is not
10 long on explanation, it just simply says "Here it is".

11 Now, on 5 July 1996 Welsh Water also made
12 submissions to Ofwat, again unchallenged, about the
13 prices paid by other prices for non-potable water. This
14 is actually at tab 6 in the same bundle. Again, it's
15 worth -- this is Welsh Water, once again, corresponding
16 with Ofwat. I want to take you to page 149, and in
17 particular the second paragraph you will see that:

18 "Welsh Water has 12 supply contracts for non-potable
19 water (see appendix 1). The supply to Shotton Paper is
20 typical of the generality of these supplies in quality,
21 quantity and distribution distance. Therefore the
22 decision regarding price concerns consideration of the
23 maintenance of a fair balance between non-potable
24 customers and customers generally."

25 We now know, of course, that this is not true.

1 There were only two partially treated water customers,
2 two other ones: Corus at Shotton and Llanwern and of
3 course Shotton Paper. Both of the Corus companies, as
4 you have heard, were paying around 14p per cubic metre.

5 THE CHAIRMAN: Oh, so Corus Llanwern was also paying that
6 amount?

7 MR SHARPE: We understand.

8 So this is attempting to justify a figure of 23 when
9 they would have known that Llanwern and Shotton Corus
10 were being paid 14, and they say Shotton Paper is
11 typical of the generality of this scheme.

12 THE CHAIRMAN: But the 12 supply contracts, that must then
13 include 9, raw supply -- raw water.

14 MR SHARPE: Not treatment at all, not even --

15 THE CHAIRMAN: One would assume at a lower --

16 MR SHARPE: It would be zero, it would simply be the cost of
17 any pumping and carriage, no treatment at all.

18 So again, respectfully, you will have to make up
19 your minds about this. This was bluntly a lie. Well,
20 perhaps I am overstating the case for once. It is
21 certainly a serious misrepresentation of the position as
22 they should have known it.

23 MR BEARD: I am sorry to interpose again. I am concerned
24 that we are drifting back to 1996. The case on
25 exemplary damages is to do with the first access price

1 in 2001. Now, in the skeleton argument, the suggestion
2 is made by the claimants that somehow what was being
3 done in 1996 was some sort of long-term strategy to
4 mislead Ofwat and soften it up so that it wouldn't
5 really focus on anything to do with the first access
6 price when a common carriage agreement was put in place.
7 That is precisely what we say is not pleaded.

8 THE CHAIRMAN: Well, what was the purpose of this
9 correspondence in 1996, Mr Sharpe?

10 MR BEARD: It's related to the bulk supply price issues.

11 MR SHARPE: The purpose was to persuade Ofwat leading up to
12 the "minded to" decision, the "minded to" decision which
13 got to 26p, and you will recall that Ofwat weren't
14 budged away from that later on.

15 I am just doing this, in a very I hope easy way to
16 take you up on the runway as to what happened. These
17 are documents you would I think have, in the ordinary
18 course, spent a lot of time on. I am leading up to the
19 situation where Albion is seeking an inset appointment
20 and wanting to adjust the terms of its bulk supply
21 agreement.

22 Anyway, none of these documents, correspondence with
23 Ofwat, were seen by Albion, although of course they were
24 central to Albion's application for a bulk supply
25 agreement. Based upon these submissions, on

1 12 December 1996, you will see this at tab 8 of the same
2 bundle, Ofwat issued its "minded to" letter. There is
3 a short bit I would like to take you to. This is from
4 Carole Begent, a familiar name to some of us, to
5 Dr Bryan, in relation to the inset appointment.

6 " So having considered the prices suggested by both
7 parties, I will be recommending to the director
8 a price" --

9 THE CHAIRMAN: Where are you reading from?

10 MR SHARPE: I am on the second paragraph at bundle 2, tab 8,
11 page 180. So this is Ofwat explaining to Dr Bryan,
12 giving him the news that 26p would be their "minded to"
13 price for non-potable.

14 Then it goes on:

15 "It may be helpful if I explained the basis of this
16 recommendation. The price for the potable water is
17 based on the cost of supplying large users, indicated to
18 us ... and adjusted for inflation. This price is above
19 the long-run margin of the cost of providing water as
20 estimated by DC."

21 It's not terribly relevant to us. Then they say in
22 one sentence:

23 "The price for non-potable water is similar to
24 prices charged by DC to other bulk suppliers."

25 So we see that they had risen to the fly here, they

1 were told that it was the same having regard to quality,
2 quantity and distribution distance, and now we know that
3 it wasn't.

4 The only category, the only class of any relevance
5 here would have been the purchasers of non-potable
6 partially treated water, and we have seen for Corus it
7 was getting 14p. So the price that they were offering
8 to sell water to Albion in respect of Shotton Paper was
9 twice as much as the so-called comparable prices similar
10 to prices charged for other bulk supply, it wasn't
11 similar at all. You can't blame Ofwat, they were just
12 repeating what they had been told. You can only blame
13 them for not verifying what Welsh Water had to say.

14 You might have thought that 26p was a pretty good
15 price for Welsh Water, from their perspective, because
16 their local costs were, let's say, 15p, splitting the
17 difference. But it served one useful purpose in that it
18 still was 1.4p less than Welsh Water was charging
19 Shotton. So what happened next is very important.
20 Welsh Water's immediate response, having refused to
21 reconsider its price to Shotton Paper previously, was to
22 reduce its retail tariff to Shotton for non-potable
23 water down to 26. In other words, it matched the
24 "minded to" price. Of course by this time, it still is
25 nearly three years before the inset appointment takes

1 effect.

2 So Shotton was being offered a retail price which
3 was the same as the wholesale price offered to Albion.
4 It's obviously before the Competition Act came into
5 effect, so no question of abuse arises. But it must
6 have been obvious to Welsh Water that it was unfairly
7 seeking to exclude Albion from entering the market. You
8 can draw your own inferences from that.

9 Now, what is also significant is Albion's own
10 reaction, it had no direct knowledge of Welsh Water's
11 actual costs, but being in the business, it had a fair
12 idea that the actual costs were way below 26p per cubic
13 metre. Faced with the chance, the reality of operating
14 at zero margin, it could have walked away, but it
15 didn't. It made a decision to enter the market, and to
16 try and fight the price, persuading Ofwat to do more
17 than a "minded to" job, and only take the inset
18 appointment once it had obtained a price that offered it
19 a viable business.

20 But this was Albion, and you have seen the evidence
21 and you can hear it no doubt more from Dr Bryan himself.
22 It was his first opportunity to enter the market, and
23 Albion took the best deal that it could at the time
24 while then trying to challenge the price.

25 There is some speculation by Welsh Water as to what

1 Albion would or would not have done in 2001. This is
2 a real life example of what it actually did do when
3 faced with a tough choice. I will be asking you to
4 conclude that Albion would have done the same if it had
5 been provided with a proper common carriage charge price
6 for Welsh Water and a commercially viable bulk water
7 supply price from United Utilities: It would have taken
8 the best price it could have got and then, if
9 appropriate, challenge the price subsequently if it
10 thought it had any basis for doing so.

11 So I give you this as a real life example of Albion
12 and Dr Bryan's instincts to fight it out, to be
13 pragmatic but above all to enter the market and prove
14 his worth. So the inset appointment was eventually
15 granted pretty well three years later in May 1999.
16 Shortly before that, Albion signed what is referred to
17 as the second bulk supply agreement with Welsh Water,
18 which you will find at tab 19 of bundle 2.

19 So we have dealt with the Heronbridge Agreement
20 whereby Welsh Water secured its supply from
21 United Utilities. This is the agreement which transmits
22 that water under the bulk supply agreement to Albion.

23 We pick it up at page 360, supply of non-potable
24 water:

25 "DC shall supply such quantity of non-potable water

1 as it may require during the term of this agreement up
2 to a maximum of 18 megalitres a day."

3 Now, as you see, that's the obligation, and you will
4 note that that is probably less than Shotton's
5 requirements, which at the time I think were about 22,
6 26 megalitres a day.

7 Then we have 1.2:

8 "Subject to availability of non-potable water,
9 an additional 4 megalitres of ... could be supplied over
10 and above the maximum providing the additional
11 quantities requested. It cannot be guaranteed."

12 I think we would call this, what, the interruptible
13 supply? But it was a risk that Albion was obviously
14 prepared to take. My understanding is it has never been
15 in issue.

16 So that's the obligation. If we go on to charges at
17 page 362, clause 4, this sets out the prices payable by
18 Albion. So we have the agreed price of 26p per cubic
19 metre, I note that was the minded price in 1996, it
20 wasn't changed, so Albion certainly wasn't going to
21 offer any more money to account for the time but they
22 were completely unwilling to offer a higher price,
23 rightly so.

24 If we look at clause 4.4, it's bearing in mind that
25 indexation is an issue, we see that:

1 "With effect from ... 1999 and for each subsequent
2 year ... charges for non-potable water shall be adjusted
3 by either:

4 "(i) The annual percentage movement in the producer
5 price index recorded the previous [year] or

6 "(ii) The percentage movement in the volumetric
7 charge for potable water", which doesn't really concern
8 us at the moment.

9 " ... whichever adjustment results in lower
10 charges."

11 So you have a choice here, the parties have hedged
12 the risk a little bit, you can either have the PPI, the
13 well-known public index, or the percentage movement in
14 volumetric prices, and the bulk supply price will ...

15 So they hedged their bets, there is a provision for
16 indexation, but it's capped by the lower of the two
17 movements, one of them essentially organised by Ofwat,
18 the volumetric movements in potable charges, or the PPI,
19 production price index.

20 So Albion began to supply Shotton Paper immediately
21 after its inset appointment was granted. The terms of
22 the Shotton Paper agreement are found in the next tab,
23 actually, tab 20. It might be easier if I took you to
24 the version of this which is in the pleading, which
25 should be bundle 10. I do that because the annexes are

1 relevant and then we don't have to faff around in
2 different bundles.

3 If you go to bundle 10, page 3348, it's annex 2 to
4 the pleading. So we have the indexation and so forth.
5 Then we go to clause 7.4, and this has an interesting
6 provision. 7 is entitled "Obligations of Albion Water"
7 and so on.

8 7.4 relates to possible cost sharing, benefit
9 sharing:

10 "Albion Water shall use all reasonable endeavours to
11 provide the customer [Shotton] with the most
12 cost-effective source of water ...

13 "The savings in the cost of supply or services or
14 incremental revenues net of financing and operating
15 costs, arising from such initiatives as may be agreed
16 between the parties shall be shared between the customer
17 and Albion Water in the proportion 70/30 respectively."

18 So the parties are going forward, and I think what
19 was in Albion's mind, and agreed with Shotton, was two
20 things, really: if the operating costs and efficiencies
21 should come onstream, then the benefits would be shared
22 between the parties, albeit not equally, 70/30 in
23 Shotton's favour.

24 The reason I took you to the pleadings was to take
25 you immediately over to annex 3. This constitutes

1 an amendment to that agreement. It is dated
2 24 October 2002. As we see:

3 "Albion is currently pursuing [this is ten years
4 ago] a complaint against DC relating to excessive
5 charging for non-potable supply. This is likely to
6 result in an appeal to the Competition Appeals Tribunal.
7 Should we succeed in this matter, it is our intention to
8 pursue DC for the recovery of monies due and for
9 a reduction in future charges. This modification
10 relates only to the claims resulting from this action.
11 Should we be successful in this action, we have agreed
12 that the benefits of any claim will be apportioned as
13 follows: recovery of Albion's costs to date,
14 apportionment of the net remaining benefit relating to
15 historic overpayment, in the proportion 70/30 in favour
16 of Albion."

17 The other net benefits would remain 70/30, so it's
18 essentially in Shotton's favour. So it's essentially
19 a sharing of the benefits that might arise as a result
20 of this action.

21 Now, of course, as the chronology shows, Albion made
22 efforts to try and renegotiate its price with
23 Welsh Water to no avail, so naturally it looked around
24 for alternatives. It turned its attention from
25 alternative supply arrangements, and if we go in

1 bundle 2 to tab 23, we begin to see the first round of
2 its efforts. This is a letter dated 20 May 1999 from
3 Albion, United Utilities.

4 We see them beginning to entertain the notion of
5 buying water, and instead of buying it from Welsh Water,
6 buying United Utilities' water directly from
7 United Utilities at Heronbridge, and as you will see it
8 refers to it being a replacement:

9 "This would represent a replacement of the
10 equivalent quantity currently supplied to DC rather than
11 increasing the overall quantity to be abstracted."

12 That's Dr Bryan -- Mr Jeffery, his colleague, it was
13 never contemplated that Welsh Water would continue to
14 take the water as opposed to retaining an entitlement.

15 It's one thing to retain an entitlement, and you
16 would expect that, if they had any future designs of
17 winning back Shotton Paper. They had a long-standing
18 agreement of a very advantageous price at cost, and it's
19 quite realistic to think they would not have
20 renegotiated that price to their detriment, why should
21 they? But it is another thing to say they would retain
22 and exploit the requirement in terms for a demand which
23 didn't manifestly exist if common carriage had been
24 secured.

25 You will also see in the same letter that Albion was

1 considering the possibility of an alternative source of
2 supply, and suggesting to United Utilities that it might
3 be interested in contributing to a such an alternative
4 source on the basis that this would allow United to use
5 the Heronbridge source exclusively for its purposes, it
6 would no longer have to supply the volume of water
7 required by Shotton Paper.

8 Now, their response is quite telling, it's over at
9 25, may I take you to that? This is United Utilities'
10 own note of the meeting and basically it says in the
11 first paragraph that they:

12 "... have no requirement for additional suppliers
13 from the Dee catchment and there was unlikely to be any
14 financial benefit which North West would share if the
15 Dee source were replaced as the supply to Shotton Paper
16 by an alternative source."

17 So it was unwilling to assist in the financing of
18 another source of water supply for Shotton Paper, didn't
19 need the water. That's an important admission by
20 United Utilities. We know there was a water surplus,
21 and so spending more money to create an even greater
22 surplus was not their idea of good business. It
23 contrasts somewhat embarrassingly with what
24 United Utilities subsequently told Ofwat in their
25 section 40A application, which I'll come on to.

1 They have more than enough water already, they were
2 then and remain today in a position of surplus in the
3 integrated zone. So they were not willing to pay
4 anything. They were effectively putting a zero value on
5 extra water which boils down to the opportunity cost was
6 zero.

7 Okay. While United was unwilling to share in
8 financing an alternative source of supply, it was
9 willing to consider supplying water directly to Albion
10 for common carriage through the Ashgrove network, and
11 you will see why in a moment, it offered significant
12 profit potential.

13 Now, you will recall that these discussions were
14 taking place pretty much at the same time as the
15 Competition Act was coming into force, and you will
16 recall that Ms White of United had made herself
17 an expert in the new legislation. You will recall her
18 first witness statement, paragraph 2. She would have
19 been well aware, therefore, of the risks of
20 an undertaking in a dominant position offering markedly
21 different prices for essentially the same service.

22 THE CHAIRMAN: Do we know the date of this meeting of which
23 this is a note?

24 MR SHARPE: It's the minute of the meeting ... 7 July 1999.

25 So after the Act had been enacted, but somewhat before

1 it came into force. We take that from the footer on
2 page 394, which I think is accurate.

3 She would have been well aware, therefore, of the
4 dangers of discrimination. Ofwat's own views on the
5 importance of the Competition Act can be seen from its
6 own publications. I am going to take you now to
7 bundle 3 at tab 31. This was a document produced on
8 12 November 1999, it's what's called one of the MD
9 series, MD for managing directors. The then
10 Director General, now Sir Ian Byatt, communicated with
11 managing directors of the 20 plus water companies from
12 time to time, setting out Ofwat's views and likely
13 policy it would take on issues of the day, and sometimes
14 to seek views as to future policy changes. This is one
15 such document, and it is of some importance.

16 It begins:

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

25 This is the link between competition law and common

1 carriage.

2 "Common carriage is possible now but few companies
3 have pursued it".

4 It couldn't be enforced.

5 "The Competition Act is the catalyst to achieve its
6 more widespread use."

7 THE CHAIRMAN: So inset appointments under the
8 Water Industry Act didn't contemplate common carriage
9 but simply bulk supply?

10 MR SHARPE: Inset appointment is essentially a bulk supply
11 arrangement which need not necessarily make use of the
12 incumbent monopolies' network.

13 So it's all coming together, bulk supply and,
14 I won't say prohibition, but the questioning of
15 discriminatory prices on the one hand of the sort we
16 have seen between Shotton Paper and Corus, and then at
17 the same time using the competition laws to seek access
18 to essential facilities.

19 THE CHAIRMAN: With the power that Ofwat had to give this
20 "minded to" price at the inset appointment, did they
21 have a power to give a "minded to" price in relation to
22 a common carriage price?

23 MR SHARPE: My understanding is not, that was simply in
24 relation to bulk supply, and that of course is the
25 context in which Albion made its application, 26p for

1 bulk supply which incorporated common carriage and water
2 resources.

3 So we have got the MD154 stating -- just alerting
4 the industry to what's going to happen, and common
5 carriage is now possible, and the Act is a catalyst for
6 its more widespread use.

7 If we pick it up over the page, he is saying we
8 should all be ready by 1 March, the date on which the
9 Act came into force, to respond positively and
10 substantively to enquiries. We will see how positively
11 and substantively Welsh Water responded to enquiries in
12 a minute.

13 Now, so that's the policy side, which I think should
14 be taken as read that Welsh Water read and understood
15 this, as did United Utilities. So what did Welsh Water
16 do? If we turn to tab 52 of the same bundle 3, this is
17 an internal document from Mr Holton. Mr Holton plays
18 a very large part in the correspondence, as you will
19 have seen, and will see more. He reported, I think, to
20 Mr Williams, and had under him various financial
21 analysts, one of whom was Mr Edwards, who is giving
22 evidence. But Mr Holton isn't giving evidence.

23 We will see from this he is writing to his
24 colleagues, and I think this paper was prepared for the
25 board as well:

1 "Competition has the potential to place some or all
2 of the following large customers at risk."

3 I am pick to go up at page 564. Sorry, I am jumping
4 ahead.

5 THE CHAIRMAN: Yes.

6 MR SHARPE: Thank you. This is in the context of publishing
7 some sort of statement of principles by the deadline,
8 giving delegated power -- second page, 562 -- and we see
9 the name Mike Brooker, who was managing director of
10 Welsh Water at the time, he is going to loom quite large
11 in our thinking, although he is not giving evidence
12 either. Mr Williams happily is giving evidence.

13 We have the background, details of the competition,
14 at 5.2, inset appointments as you see, abstraction
15 licence trading, which happily doesn't worry us, common
16 carriage.

17 We see the importance of common carriage, in
18 particular if you have got water supply producers and
19 common carriage, that's a necessary and sufficient
20 condition for efficient competition. So both parts come
21 together. And that can come together if the company
22 owns the pipeline and has the water resources.

23 Anyway, then we have possible outcomes of
24 competition. Then over the page at 5.3, we have
25 a breakdown of the large users, all of whom who would be

1 at risk if common carriage were granted. As you see,
2 the total sum is at the top, the total sum of
3 £23.4 million -- 23.8 million, I beg your pardon.
4 23.8 million was at risk.

5 So from this we can infer that Mr Williams, at
6 least, was right up to speed on the implications of the
7 Competition Act 1998, and in terms of the competitive
8 threat, there is no doubt at all that the most
9 compelling threat comes from Albion, and we can show
10 that if we turn back, I am afraid, to bundle 2. As you
11 know, the bundle is in chron. Tab 14.

12 Now, this is an internal Albion document dated
13 I think mid-1998. It gives a list of the outstanding
14 bids made by Albion as at 1 May 1998 for inset
15 appointments. You will see that at page 265.

16 Now, these aren't the bids just made by Albion,
17 I misspoke, these are all the bids received by Ofwat as
18 at that date. There were 32 inset applications, and of
19 these no less than 30 have been made by Albion. Albion,
20 Enviro-Logic, ELL, but I think by now you know that's
21 Albion.

22 THE CHAIRMAN: This is across the whole country?

23 MR SHARPE: England and Wales.

24 THE CHAIRMAN: Yes.

25 MR SHARPE: I mentioned at the beginning Albion were really

1 taking this question of introducing competition very
2 much to heart, they always wanted to be the market
3 leaders in inset appointments and offering competition
4 and choice to customers, and you will see Shotton is
5 isolated there. But another Welsh Water DC is outlined
6 at number 31, Kimberly-Clark. Actually I won't take you
7 to it, but in fact perhaps somewhat naively Albion had
8 written to Welsh Water indicating its ambitions and
9 wanting to know Welsh Water's intentions regarding
10 common carriage. I won't take you to it, it's a note to
11 Mr Brooker, the managing director of Welsh Water, and
12 for your note it's bundle 3, tab 41 at page 517.

13 In retrospect it was a remarkably naive letter, with
14 the greatest respect to my client. "We propose to
15 essentially compete against you", that's what it said.

16 So there was no doubt at all in the course of 1999
17 at least, that Welsh Water knew that if common carriage
18 proved to be a viable route then substantial revenues,
19 as outlined in the document, were at risk from Albion or
20 anybody else, but primarily Albion, who had made 30 out
21 of 32 applications.

22 At this time, Welsh Water, in terms of how they
23 should approach common carriage, it's clear responding
24 to MD 154, the Ofwat document, that Welsh Water was
25 considering how it should deal with this and how it

1 should calculate prices. I am going to give it to your
2 note but I am not taking you to it. It's an internal
3 note of 24 January 2000, which you will find at
4 bundle 3, tab 35.

5 The only relevance of that, again for your note, is
6 that it's important to look at the problem top-down and
7 bottom-up: top-down looking across the piece and
8 bottom-up looking at actual costs incurred.

9 Now, in terms of how it should approach access
10 pricing and carriage, Welsh Water did have the benefit
11 of guidance from Ofwat. The most up-to-date guidance
12 you will find at tab 3, bundle 3 rather, tab 59. This
13 is another managing director letter, MD 163. It is of
14 some considerable importance. Whereas the earlier 154
15 document had been something in the way of a consultation
16 to industry, and indeed received responses from
17 industry, here we have something approaching definite
18 conclusions on the part of Ofwat.

19 This document is important for another reason,
20 because this essentially purports to be the
21 justification by Welsh Water for their, I call them
22 accounting contortions, their method of operating, and
23 in particular it's a justification for its chosen
24 approach using regional average cost data for potable
25 circumstances in order to divine the correct treatment

1 charge for the limited treatment which took place of
2 unmanned Ashgrove Water Treatment water and also the
3 correct distribution charge for non-potable, in this
4 case, gravity pipeline.

5 We can, I think, pick it up at page 611 where it
6 says:

7 "Main approaches to access pricing.

8 "In assessing disputes or complaints about access
9 pricing, Ofwat will focus on the effect of the price on
10 competition in individual cases and on the cost
11 information on which it is based. Nevertheless, it is
12 instructive to review the approaches that companies have
13 considered."

14 Pausing there, we see here the primacy, the effect
15 on competition in individual cases. We are going to
16 probably have some debate about what that means.

17 I think it's perfectly clear, if you are going to
18 eliminate competition, think again, or at least subject
19 your data to rigorous scrutiny.

20 There are many different ways of calculating access
21 prices but the list of alternatives can be grouped into
22 three main approaches, specifically access prices can be
23 based on, and it says accounting costs, that is to say
24 the book value of the assets to which access is sought.

25 Now, pausing there, we are not talking about assets

1 to which access is not sought, or assets which could be
2 somewhere in Crewe or in Penrith, we are talking about
3 assets and activities which operate, to which access is
4 sought. If we descend to the level of this case, we are
5 talking, are we not, Ashgrove pipeline treatment modest
6 transmission.

7 But we also note that this seems to have been,
8 according to Ofwat, the industry's preferred method:

9 "Most companies have indicated they intend to charge
10 for use of their systems principally on the basis of the
11 book value of their assets."

12 Then the second one, the long run marginal costs,
13 LMRC, of that part of the incumbent system to which
14 access is sought. Again to repeat, this is that part of
15 the system to which access is sought, this can only be
16 Ashgrove, gravity fed pipeline, which doesn't mean some
17 other LRMC in relation to all of Welsh Water's
18 activities.

19 So the guidance offered here seems to me at least to
20 be clear. Thirdly, the efficient component pricing rule
21 I which came and went in earlier proceedings and I don't
22 intend to dwell on it.

23 "There is no suggestion here that it is appropriate
24 to price services by reference to the average cost of
25 providing those services across the supplier's entire

1 region. Still less is it suggested that it would be
2 appropriate to price services by reference to the
3 average costs of providing the completely different kind
4 of service."

5 When I take you to Welsh Water's gymnastics in
6 arriving at an access price for non-potable water from
7 potable water data, reflecting as they do very different
8 costs, you might bear that in mind, two separate
9 activities. Now, why did they choose that? In my
10 submission, it's obvious, in order to arrive at a higher
11 figure.

12 Having told Welsh Water in February 2000 that it
13 intended to apply for common carriage, Albion made its
14 formal application for common carriage in relation to
15 Ashgrove on 28 September 2000, and for your note it's
16 bundle 3, tab 62. They had been considering common
17 carriage for at least nine months. They had been told
18 to respond, Welsh Water had been considering pricing for
19 common carriage for at least nine months, they had been
20 told by Ofwat that it needed to be ready to respond
21 positively and substantively to applications by 1 March,
22 seven months earlier.

23 They should have therefore been in a position to
24 respond quickly to the common carriage application, and
25 as we now know, Welsh Water's internal accounting

1 provided local cost information covering both the
2 operating costs and assets involved for the
3 Ashgrove System, the assets to which access was sought.
4 That was the local accounting information and the local
5 asset register which Welsh Water finally revealed
6 I think it was in 2006.

7 THE CHAIRMAN: That's the D21?

8 MR SHARPE: No, it is not, with respect. D21 is the 1996
9 internal tabulation of the local costs, but I think we
10 are talking about here the asset register weren't we,
11 which was revealed by way of disclosure in Mr Jones'
12 second statement in 2006. Yes, 2006.

13 So they had the information, but notwithstanding the
14 exhortation from Ofwat, they chose not to progress the
15 matter with the expedition that the Director General, at
16 that time, wanted.

17 Now, then, I said I would set the scene, and I have
18 taken quite a long time in doing it, but I hope you have
19 found it useful to go to some of these primary documents
20 to see what was going on at the time.

21 I am now going to turn specifically to the issues,
22 the matters leading up to the issue of the abusive FAP.
23 I am going to focus on Albion and Welsh Water because
24 they were the parties concerned, but to the side of the
25 stage of course we have United Utilities. They are not

1 offstage, because unless Albion could get a good deal
2 for a bulk supply, no amount of common carriage would
3 have been any use to them, unless you got a good deal
4 for common carriage, even a very generous bulk supply
5 settlement would have been no use to them either. So
6 they had to have both balls up in the air at once.
7 There was no question of signing for one without having
8 an agreement in place. Indeed, the parties themselves
9 understood they had to co-ordinate, and you have seen
10 reference to at least one tripartite meeting where
11 technical issues were discussed and where we understand
12 United Utilities were telling both parties the sort of
13 price that it was going to charge for bulk supply. We
14 will come on to that.

15 Now, I am wondering whether it might be a convenient
16 moment, because we are moving on to quite a distinct
17 topic.

18 THE CHAIRMAN: Yes.

19 MR SHARPE: Madam, I'm probably just a little over halfway.

20 THE CHAIRMAN: Right.

21 MR SHARPE: I said up to a day, and I am afraid I'm probably
22 going to do that.

23 THE CHAIRMAN: Very well. We will come back at 2 o'clock.

24 MR SHARPE: Thank you.

25 (1.00 pm)

1 (The short adjournment)

2 (2.00 pm)

3 MR SHARPE: Albion formally wrote to Welsh Water on
4 28 September 2000. You will find that in a bundle I'm
5 not taking you to, bundle 3 tab 62. They had
6 discussions before then, as you have seen.

7 After three weeks, Welsh Water responded with a two
8 and a half page questionnaire on 18 October, for your
9 note, I'm not taking you to it, bundle 3/65. This
10 appears to be a standard questionnaire, directed to all
11 applicants for common carriage, though we have no
12 knowledge of any others, actually, and why it took them
13 three weeks to issue it is a mystery and Albion
14 responded within two days of receipt, and for your note,
15 bundle 3, tab 66.

16 There is a complete absence of documentation showing
17 what Welsh Water did in response to the application and
18 the questionnaire duly completed, but we do have, for
19 curiosity, bundle 3, tab 68, which I will take you to
20 quickly. This is an invitation to tender from, no
21 doubt, consultants, two consultants I am told. It is
22 dated some time in October.

23 THE CHAIRMAN: October 2001?

24 MR SHARPE: No, 2000.

25 THE CHAIRMAN: 2000, yes, sorry.

1 MR SHARPE: So the application was made in September 2000,
2 and this is Welsh Water, in response to the introduction
3 of the Competition Act, Welsh Water produced an NAC,
4 a network access code, which advocates regional average
5 prices in line with Ofwat's current position. You can
6 guess my submission on that, I will not dwell on it now.

7 "Welsh Water would like to calculate local costs in
8 order to be ready to respond to competitive threats. We
9 have invited a small number of selected consultants to
10 bid for the provision of methodology for determining
11 these local prices and a report detailing their
12 quantum."

13 It goes on "working method", "submission of tender".
14 That consultancy tender process was due to be completed
15 by 31 October 2000, and I guess its results would have
16 been very interesting, because they would have provided
17 some indications, some insights, into the local costs
18 which would have enabled Welsh Water to be ready to
19 respond to competitive threats.

20 Well, I must report that Welsh Water have been
21 unable to produce any documents in relation to that
22 tender work, and what analysis emerged or indeed if any
23 analysis was conducted at all, but either way it's the
24 best I can do. Suffice to say for our purposes it would
25 have been very valuable to know what data they were

1 given and what conclusions they would have reached or
2 maybe did reach.

3 We know, and I've shown you, D21 shows that for
4 a simple system like Ashgrove, the stand-alone network
5 supplying two customers only, one would have thought
6 Welsh Water wouldn't have needed the assistance of any
7 consultants of any description, it had its detailed
8 accounting record, and it knew what the position was,
9 the parameters. It had to have very generous allowances
10 for management on-costs which, as you saw they
11 subsequently revised very dramatically, and they knew
12 that if that were right, if you took away those inflated
13 items, you would have had a local cost based price for
14 common carriage in the order of 12p, subject to any
15 increases in costs which might have been provided for to
16 the year 2000.

17 Therefore, as Welsh Water were well aware, any price
18 based on local costs would lead to a substantial
19 reduction in revenue for Welsh Water, compared to the
20 26p price they were receiving from Albion following the
21 "minded to" Ofwat letter. Of course that immediately
22 exposed them to the loss, I have said it several times,
23 of about 800,000 potentially.

24 So presumably well aware and briefed of these facts,
25 Welsh Water's board decided it can only maintain revenue

1 neutrality if it could apply an average cost of
2 distribution, not a local cost of distribution but
3 a charge based upon average costs for common carriage.

4 Here I am going to take you to the minutes, the
5 short minute, bundle 3, tab 75. This is all we have of
6 the minute, and that's not meant as a criticism, it's
7 very short. Page 685. So we have Mr Brooker in the
8 chair, we also see Mr Williams, who is giving evidence,
9 and I am instructed -- though I could be corrected --
10 that the Mr Edwards here is not our Mr Edwards in these
11 proceedings, it's another Mr Edwards. It is
12 Welsh Water, I'm surprised there aren't more Edwards.

13 Anyway, what we have, this is a document that
14 emerged fairly late in the whole proceedings in the
15 course of the referred work. We see the competition
16 update and the only thing that's relevant I think is
17 4.4.2:

18 "Application to be made by Enviro-Logic [Albion] for
19 common carriage of water acquired from North West Water
20 to the customer at Shotton Paper. This will have
21 a relatively neutral cost effect for Welsh Water for as
22 long as average cost of distribution can be applied to
23 such arrangements."

24 So they have obviously applied their minds, been
25 briefed, as to the consequences of Albion coming in, and

1 I guess the discussion reflected in this minute was
2 simply: well, this could be tough, these people are
3 aggressive, by this time they would have known Albion
4 had made 30 out of 32 applications for common carriage,
5 but it will be okay if we can judge our charges based
6 upon average cost as opposed to actual cost, because we
7 know what our actual costs are, they are much lower.

8 That's the first minute I am going to take you to.
9 There are many others.

10 Pausing there, even if we can make sense of
11 something called average cost of distribution, not local
12 cost based, what does that mean? Average cost of what?
13 Well, one candidate would be the average costs of the
14 customers who fall into that class of customer in which
15 Shotton Paper exists, is in. What is that? Large,
16 industrial user, taking non-potable water which had been
17 partially treated. As I've submitted already, as
18 a matter of evidence there are only three such
19 customers. Two of them were Corus and the other one was
20 Shotton.

21 So it wouldn't be an average cost of distribution
22 for the product which Albion wanted, that is to say
23 partially treated non-potable water, and one assumes
24 that the cost of Llanwern, the other partially treated
25 system, was broadly the same as Shotton. I have no

1 evidence to that effect, but it's not an unreasonable
2 assumption people doing the same thing, same steelworks,
3 everything else. If you took an average of that, it's
4 basically actual costs of supplying. If you did it that
5 way, you would produce something very similar to the
6 local costs of distribution. You may recall that that's
7 precisely what the Tribunal did in the end.

8 So of course if they had gone down that route, there
9 was a big margin which Albion would have eaten into, and
10 profits would have fallen. Non-potable distribution is
11 much cheaper than potable distribution. So the same
12 problem would essentially have arisen even if they had
13 looked at the average cost of non-potable distribution
14 across Welsh Water. The only way -- let me pause for
15 a moment. The justification, the factual justification
16 for the difference in distribution prices, and they are
17 quite striking, is found in Dr Bryan's statement, which
18 you will find at bundle 1, tab 4, paragraph 243. May
19 I take you to this quickly?

20 THE CHAIRMAN: Yes.

21 MR SHARPE: You may recall this. He is adverting to his
22 earlier statement in 2006. I think for our purposes, if
23 you could just scan this, because I don't think --
24 I hope it's not in contention in any event, but it's
25 an important point. Potable water is very obviously

1 intended to be drunk, it's for human consumption.

2 Just to briefly explain the difference, potable
3 water is intended for human consumption, it therefore
4 has to be treated, and it's treated in this country to
5 a high level to make it potable. Because it's treated
6 to a high level and it costs money to do that, it is
7 also valuable, and therefore when it's distributed it
8 has to be distributed in pipes which don't leak, which
9 don't corrode, and don't affect the safety and
10 potability. So you can really see that the combination
11 of circumstances which create costs which for raw water
12 and for non-potable water are simply not relevant.

13 Of course the consequence of the leak, leaking away
14 valuable treated expensive water is both financially
15 and, it must be said today, reputationally significant.
16 So in order to avoid that and the risk of contamination,
17 leaks are avoided.

18 Now, this evidence isn't in contention, but he
19 explains it more succinctly than I am capable of doing.
20 So the simple point, potable water distribution is
21 significantly higher, orders of magnitude higher than
22 the distribution of non-potable water, and is therefore
23 more expensive.

24 Just touching Welsh Water's position. They had got
25 internal data on average cost. Sorry, they had got

1 internal data on actual costs incurred, they have
2 alighted upon average cost as a means of breaking away
3 from a narrow focus on local cost, but at the same time
4 the only average cost they can properly average are the
5 average costs of the same type of customer, non-potable,
6 partially treated customers, but it so happens Shotton
7 is one of the three and the others are Corus. So they
8 are in a bit of a bind, because they want to get as near
9 to 26p as possible in order to achieve what in my
10 submission is a fairly obvious intention, and that is to
11 keep Albion out of the market allowing of course for
12 water resource cost.

13 So they have alighted upon average cost. Following
14 their board meeting on 6 November, Welsh Water agreed to
15 meet Albion on 10 November 2000, and you will find that
16 in bundle 3, tab 79, a couple of tabs on. May we go to
17 that? Here you will see on the second page, 697, after
18 all the cordial introductions and so on, DH, and that's
19 Mr Holton, who is not with us, is responding to
20 Dr Bryan, I think, his statement, that Welsh Water have
21 de-averaged the charges for Shotton and Corus and you
22 will see his reasoning at the bottom of the previous
23 page. More importantly, what Mr Holton says is that:

24 "Albion's understanding was misplaced and that the
25 tariffs for all non-potable water, including Shotton,

1 was based on average price methodology and adapted to
2 individual circumstances. He referred back to pricing
3 methodology in the justification of Welsh Water's
4 revised non-potable tariff for Shotton Paper, following
5 Ofwat's indicative price determination of 26p per cubic
6 metre. All he wanted to do was to employ a similar
7 approach for this application."

8 Well --

9 THE CHAIRMAN: The word "tariff" there just means price, it
10 doesn't have a connotation of some published level of
11 charges --

12 MR SHARPE: Not at all. Far from it.

13 THE CHAIRMAN: -- because you said these are all --

14 MR SHARPE: These are all bespoke.

15 THE CHAIRMAN: -- bespoke contracts, yes.

16 MR SHARPE: Now, let's just take this apart slightly. It
17 was based on average price methodology and adapted to
18 individual circumstances. It doesn't quite explain what
19 he means by that. You either have average prices,
20 charges, tariffs based upon average prices, or you have
21 them adapted to local circumstance. How do you adapt
22 an average price to local -- does that explain halving
23 the tariff for Corus and having twice as much for
24 Shotton? If they are based upon the same data, and your
25 averages, they should be the same. But they weren't.

1 What's more, I hesitate to say this again, but Mr Holton
2 would have known that. So what's he doing telling
3 Dr Bryan something which bluntly is not true?

4 MR BEARD: I am sorry to rise again in relation to it, it's
5 the same issue I've raised before. It's unpleaded.

6 THE CHAIRMAN: It's an interpretation of a document, you
7 will have your opportunity no doubt to say what
8 interpretation you place on this document.

9 MR BEARD: Yes, it goes a bit further than that, Madam
10 Chairman. If the allegation is that Mr Holton was lying
11 in those circumstances, which has how it has been put in
12 the skeleton argument that has not been pleaded, that
13 goes further and that is not a matter that can be
14 properly pursued. Interpretation of documents, of
15 course we can argue about. But this needs to be on the
16 basis of a pleaded case, and the pleaded case in
17 relation to exemplary damages is extraordinarily narrow
18 in terms of its pleading. Indeed, it got narrowed by
19 this Tribunal at a previous hearing whereby a ruling,
20 and numerous references that were included in the
21 previous pleading, were eliminated.

22 THE CHAIRMAN: Those were, as I recall, related to matters
23 after the issue of the price. Anyway, I don't want to
24 get into a debate about it with you now. Let Mr Sharpe
25 finish his submission, and then we will see where we

1 are.

2 MR BEARD: Thank you.

3 MR SHARPE: I am very much obliged. I can put the case and
4 say he is lying, a hard thing to say; I can put the case
5 on the basis of the document and compare it with what we
6 now know from other documents and say simply it was
7 untrue. But Mr Holton knew both sides of the story, so
8 you can draw an inference that he was being economic
9 with the truth or otherwise. I certainly don't need to
10 plead each and every part of particulars of evidence.
11 My friend has rather confused pleading and evidence.
12 But I am delighted, Madam, that you will allow me to
13 proceed.

14 So that's the first point, what on earth is meant by
15 adapting to individual circumstances, how does that
16 square with the Shotton Paper/Corus discrepancy?
17 I don't think it could be based upon average cost, it's
18 one or the other.

19 Secondly, we go back to sludge tankering, the
20 second -- that dealt with sludge. I am not going to
21 devote any further energy to sludge. It can come out in
22 the evidence, at least Mr Edwards will have to explain
23 what Mr Holton meant. Again, it is unfortunate
24 Mr Holton should not be called to justify his own
25 actions and words. But there was simply no sludge

1 tankering at Ashgrove, and no significant costs were
2 involved, and that's Dr Bryan's evidence, and if they
3 want to challenge it, Dr Bryan at least is here.

4 Then they say Welsh Water stated that access price
5 will be issued shortly as a fairly simple case of
6 updating existing methodology with current data. That's
7 6 November. Of course, as we know, that is not what
8 happened. It didn't come shortly, it came in March of
9 the next year, and it certainly wasn't simple, as I am
10 afraid I am going to inflict upon you in a few minutes.

11 So by the end of November, as we can see from the
12 internal Welsh Water email of bundle 3, tab 85, which
13 I am inclined to take you to, if you go to it briefly.

14 Welsh Water was refusing to tell Albion either the
15 price or the methodology that it used to produce the
16 price. So one minute they are told it's a simple case
17 of updating the existing methodology, and then a week
18 later but certainly Mr Holton tells Mr Edwards:

19 "Discussion: for various reasons we don't want to
20 give them our methodology. Suggest I ring him tomorrow
21 and say that prices will be determined" --

22 THE CHAIRMAN: Jerry is presumably Dr Bryan?

23 MR SHARPE: Dr Bryan:

24 "... and say that prices will be determined as in
25 the NAC actual methodology is commercially

1 confidential."

2 Well, we will come back to that. Either way, for
3 various reasons; I am going to give Mr Edwards very fair
4 warning, and I am sure it will be communicated to him,
5 that I am going to ask him what on earth he means by
6 various reasons. We have had one explanation in the
7 skeleton which doesn't hold water, and he has a week or
8 so to improve upon it.

9 Now, it seems abundantly clear at this time that
10 Welsh Water had not yet managed to find a suitable
11 methodology. What's a suitable methodology? The price
12 that they wanted, that is to say the one that provided
13 revenue neutrality. Here I am getting to the nub of the
14 issue. From what now follows, it seems pretty clear
15 that what Welsh Water wanted to do -- and who can blame
16 them -- was not to lose revenue. How do they not lose
17 revenue? Well, they generate a price which makes it
18 uneconomic for Albion to proceed. So that's got to be
19 as high a price as possible. We see from the board
20 minute that the board was acutely -- was certainly
21 conscious, as it obviously had discussed the matter, but
22 the way of dealing with that was to say well, look at
23 average distribution costs, and we will just think about
24 in a moment what we mean by that, as opposed to actual
25 distribution costs where we know what the result says

1 from our internal work, which I have already showed you.

2 The first attempt to calculate a price which has
3 been disclosed is Mr Henderson's email, and that's at
4 90. You may remember this is the one we are all
5 expected to eat, eat this email, once you have read it.
6 That's sort of dismissed, incidentally, as light-hearted
7 banter. They must be a very po-faced lot at Welsh Water
8 because there is not much light-hearted banter in the
9 rest of this documentation. I am prepared to think that
10 what Mr Henderson meant was: this is an email of some
11 sensitivity, and eat it, dispose of it.

12 What did he do? This is again to Mr Holton but also
13 Mr Edwards. First of all, he is not attempting to
14 calculate the actual costs involved in this or in any
15 other service. That's the first point.

16 What he is trying to do is to find a justification
17 for a price of around 26p per cubic metre, which is what
18 Albion was seeking which is what Albion was being
19 charged.

20 That was presumably one of the reasons why he says
21 "eat the email". I don't want to go into this email at
22 great length, partly for the question of time, but
23 partly I will have a few words with Mr Edwards about it.
24 So I will try and summarise it, so that the
25 cross-examination when it comes will be more

1 intelligible.

2 What he is trying to do, what he is proposing is
3 using a Large Industrial Tariff, that should be in
4 capitalised letters, LIT, you see, for potable
5 customers, which at the time I think was the only
6 industrial tariff that existed, and then deducting the
7 additional costs involved in potable treatment. So you
8 would then, by implication, have a figure for common
9 carriage of potable water.

10 You have the tariff, you deduct the additional costs
11 involved in treatment, that is to say to render it
12 potable, and then the residue is deemed to be
13 distribution.

14 So the end result would be a price based on average
15 potable distribution costs. Now, that of course would
16 be much higher than the distribution costs for
17 non-potable water for the reasons I explained a few
18 moments ago, transporting potable is an infinitely more
19 expensive proposition than non-potable water.

20 THE CHAIRMAN: Even just transporting it once it's treated
21 through a big pipe?

22 MR SHARPE: Different pipes.

23 You have two things. We are talking about treatment
24 here, we are talking about the treatment operation
25 required to render raw water drinkable.

1 THE CHAIRMAN: Yes, but they were deducting that. It is
2 potable minus the cost of potable treatment, and then
3 minus the use of the small pipes in the network, the
4 cost of local distribution.

5 MR SHARPE: Yes. But the simple point is that the
6 distribution of potable water, because the water is
7 pushed under high pressure, as Dr Bryan says, because it
8 has to be renewed fairly regularly to avoid
9 contamination and leakage, costs of potable
10 distribution, I showed you this earlier, are
11 significantly higher than the costs of distribution of
12 non-potable water.

13 THE CHAIRMAN: Yes.

14 MR SHARPE: Okay?

15 THE CHAIRMAN: Yes.

16 MR SHARPE: So pausing there, we have the large industrial
17 tariff of potable customers, we deduct the costs
18 involved in potable treatment and you are getting the
19 potable distribution costs, average potable distribution
20 costs, and then you assume that the treatment charges
21 for potable/non-potable are correctly calculated ...
22 assumptions are made about the cost of treatment of
23 non-potable water. Again, at that time nobody looked at
24 the actual costs of treatment for non-potable water as
25 compared to the treatment required to make water

1 potable.

2 A rough and ready figure -- I'll come on to this
3 later -- of 30 per cent of what it costs to render water
4 potable, is deemed to apply for non-potable, and we will
5 see later that is approximately 100 per cent more than
6 it should be from Welsh Water's own internal
7 documentation, but we will come on to it.

8 So that's what Mr Henderson was attempting in
9 November, at the end of November. By mid-December, they
10 had had two and a half months to produce a common
11 carriage price, but had not given Albion any indicative
12 price. At this stage, Ofwat was getting concerned it
13 was taking too long, and Ofwat actually received
14 a complaint from Albion to the effect that the delays
15 were themselves abusive. For your note, but I am not
16 taking you to it, bundle 3, tab 96.

17 So despite having told Albion and Ofwat that price
18 couldn't be issued until after the December board
19 meeting, Welsh Water had not in fact calculated the
20 price which the Welsh Water board could consider at that
21 meeting, and as a result no price was issued to Albion
22 in December 2000. There is a minor issue: Mr Edwards,
23 at Edwards 1, paragraph 37, said that the board had
24 insufficient time to deal with it, so the matter wasn't
25 put to the board.

1 That was one explanation in his evidence. Another
2 one would be they had nothing to put to the board, all
3 they had was Henderson, and in a nutshell they had
4 hardly started the process of calculating this.

5 By the end of December they started in earnest, and
6 we see this in a document entitled "The Network Access
7 Price" which you will find at bundle 9, tab 354. I am
8 afraid I am obliged to take you to this as well. Folder
9 9A, we divided them up because I think we are getting
10 a bit creaky. 354.

11 THE CHAIRMAN: Yes.

12 MR SHARPE: Now, to some extent this followed the same
13 methodology as suggested by Mr Henderson. That is to
14 say, it starts calculating the potable distribution cost
15 from the large industrial potable tariff, and then it
16 calculates a treatment charge for non-potable water.
17 The calculation itself includes two separate
18 calculations of the price. Both calculations used the
19 same method, and they are based upon exactly the same
20 accounting data, but they come to widely different
21 prices. One assumes a water resource cost of 12.65, and
22 you see that at page 3283, the summary. So you have two
23 assumptions about water resources. One assumes that
24 water resources cost 12.65p, you will see that at
25 page 3283, while the other assumes that water resources

1 cost 21.34, and based on this the cost of bulk -- 21.34
2 is on the last page, 3288.

3 THE CHAIRMAN: The 12.65, that is what Welsh Water is
4 saying is the average price that they pay for water?

5 MR SHARPE: Yes. It's cost.

6 MR LANDERS: Sorry, can you say where on page 3288 you see
7 that number?

8 MR SHARPE: Yes, if we go to 3283, you have "Summary",
9 step 4, walk through the document.

10 MR LANDERS: That's fine, yes.

11 MR SHARPE: Full breakdown of the potable price, so as you
12 say it is the average cost of it. Then the other
13 assumption which you will find at 3288, water resources,
14 costs 21.34. It is in fact the third clutch of data
15 from the bottom. "So the total breakdown of potable
16 price is".

17 MR LANDERS: Can I check what we are doing: is it the case
18 that in both cases we actually started with the 83.74
19 tariff and then divided it up?

20 MR SHARPE: Yes.

21 MR LANDERS: So it's not costs?

22 MR SHARPE: Well, it's --

23 MR LANDERS: You are not starting from the cost, you are
24 starting from the tariff and then saying how we break up
25 the 83.74 between these elements?

1 MR SHARPE: That is the formal position. I think what I was
2 trying to do here wrongly is elide the tariffs which are
3 based on cost, let's leave that aside --

4 THE CHAIRMAN: That 83.74, is that a regulated price?

5 MR SHARPE: The potable price would be. No, no, this is for
6 industrial ...

7 MR LANDERS: So we are starting from the price that's being
8 charged, and then we are saying we need to get some
9 costs that come back to it, and we have two ways of
10 doing it.

11 MR SHARPE: Yes.

12 THE CHAIRMAN: You start from the potable price and you work
13 out what it is you are charging the customer for, and
14 then you work out how many of those things you are also
15 going to be charging a common carriage customer for or
16 the things that they are not using and then deduct
17 those --

18 MR LANDERS: But the assumption in both cases is that the
19 total of the costs is the same as the price?

20 MR SHARPE: Yes.

21 MR LANDERS: Which is --

22 THE CHAIRMAN: That's why I asked if these are a regulated
23 price.

24 MR LANDERS: -- in most industries, so there is no profit
25 or anything in there, is there?

1 THE CHAIRMAN: Yes, profit.

2 MR SHARPE: What would happen is the Regulator, if there
3 were regulated, would be allowing the reasonable return
4 of capital so that is included in the price.

5 So what we have here are two values for water
6 resources, because they are deducted, you then generate
7 a figure for bulk distribution, because they are
8 different numbers the cost of bulk distribution will
9 itself differ, but it differs as between 24.97, which
10 you will find again at 3283, by a process of -- you have
11 seen the figure. 0.2497, and in the last page, potable
12 bulk distribution, and you see the same ... on the final
13 page, bulk distribution at page 3288, point 1301.

14 Now, if you are having difficulty understanding
15 this, may I say I share that difficulty, because both
16 calculations were apparently based upon the same
17 accounting data and the range of outcomes is frankly
18 bewildering.

19 I am going to pass on, because when I cross-examine
20 Mr Edwards, he no doubt will make it all very clear.

21 MR COWAN: Just by way of clarification, resource I assume
22 means water?

23 MR SHARPE: Yes. Just to round off. You have these two
24 prices, two values for bulk distribution, they used the
25 same 30 per cent multiple to deflate the cost of potable

1 treatment by 30 per cent to arrive at a presumed value
2 of the cost of the treatment of non-potable water.
3 Okay? And they did that in both methods of calculation.
4 THE CHAIRMAN: Even though, as far as that potable water --
5 the non-potable water was concerned, as we have seen
6 there were 12 contracts of which nine were for raw water
7 and three were for partially treated water, so the
8 average cost of treating the non-potable water, one
9 would expect to be considerably lower than the cost of
10 treating the partially treated part of that non-potable
11 water.

12 MR SHARPE: That would certainly be true, but in either
13 case -- but here they are looking at the cost of
14 treatment of potable water, not the cost of treating
15 non-potable water, and making an assumption that the
16 costs of treating all forms of non-potable water, in
17 this case, would be 30 per cent. That wouldn't include
18 all water. So we are only talking here about partially
19 treated water.

20 The point I thought you were going to make was this:
21 the only costs they could have and needed to look at for
22 the treatment of non-potable water would be the costs
23 incurred at Corus and Shotton and maybe Llanwern.

24 THE CHAIRMAN: That was not quite the point I was going to
25 make, but it's the point you are making.

1 MR SHARPE: Yes. Have I answered your question?

2 THE CHAIRMAN: I think we will have to come back, as you
3 say, to that document.

4 MR SHARPE: You start off with a value from the treatment of
5 bulk potable water, X, you make an assumption that
6 non-potable water's treatment costs will be X times
7 30 per cent. There will always be 30 per cent of
8 potable treatment. That has been the assumption --

9 THE CHAIRMAN: Wait I minute, I thought you said they
10 deducted 30 per cent from the potable --

11 MR SHARPE: No.

12 THE CHAIRMAN: So then they would say that the cost was
13 70 per cent.

14 MR SHARPE: No, no, no, no. I didn't say that at all. If
15 I did, I didn't mean it. It constitutes 30 per cent.

16 THE CHAIRMAN: Okay.

17 MR SHARPE: That I hope rings true, bearing in mind the
18 evidence that you have been taken to, and you will no
19 doubt refresh yourselves on, of the costs of treating
20 potable water are necessarily significantly higher,
21 necessarily higher to make it drinkable.

22 We are talking here about treatment, not
23 distribution. So distribution costs are not very high in
24 relation to non-potable water, costs of treatment of
25 potable water are much, much higher than the cost of

1 treating non-potable water.

2 Now we go to bundle 3, which represents the next
3 attempt to calculate the price, and we go to tab 110.

4 I think it's the last tab in the bundle. This is
5 a document dated -- it's not dated but we think it's the
6 end of December 2000, and before looking at it in
7 detail, let's remember the background to it. We know
8 from an internal email exchange that a draft of this
9 document was being circulated within Welsh Water on 17
10 and 18 December, and for your note but I am not taking
11 you to it, bundle 3, tab 103. Well, I think I will take
12 you to it because it might actually assist you
13 understanding this better.

14 So forgive me, let's very quickly go to that.
15 Tab 103, it's just one page. This is helpful and
16 unhelpful. What it indicates, we know that a draft was
17 circulated, Mr Holton sends this to Jackie Boarer,
18 Mr Edwards, colleagues in Welsh Water, this is the
19 bottom email first:

20 "First cut ... not much time for subsequent cuts.
21 Draft of LiCo [and that's the internal committee] ...
22 attempted to produce a series of modular paragraphs that
23 can be ordered to suit the logic and objective -- Hope
24 most angles are covered -- pretty rushed in order to get
25 the pre-qual [and all the other work he has to do] ...

1 have a look if you get a chance and then you can
2 hopefully to find some time tomorrow to hack it about."

3 So off it goes to Mr Edwards. Here we are:

4 "Sorry I'm not in til tomorrow ...

5 "However have had a quick look at the paper,
6 rearranged it slightly -- this paper would be used in
7 any formal [Competition Act] case, and has been
8 rewritten with this in mind."

9 So this is evidence of Mr Edwards rewriting
10 Mr Holton's paper, and then sending it around the houses
11 to Boarer, Holton, and also adding Paul Henderson. Or
12 perhaps Ms Boarer or somebody added Mr Henderson in, but
13 it doesn't matter. The reply from Jackie Boarer adds
14 Henderson to the list.

15 Going back to Edwards:

16 "I thought Paul [that's Henderson] was getting the
17 asset info to calculate a stand-alone non-potable
18 tariff, not to look at the company average non-pot
19 element of all treatment works. Is he doing that as
20 well?"

21 Do you see what's going on? This is one of those
22 examples that we now know that somebody, Mr Henderson,
23 was doing some work on stand-alone assets, we don't see
24 it. It's not in the bundle. It doesn't emerge, and
25 I can't ask Mr Henderson that because he is not giving

1 evidence.

2 What's interesting, also, and I hope I am allowed to
3 simply draw your attention just to explain some gaps
4 here, if you allow to anyway, this refers to a document
5 Mr Holton produced which went to Mr Edwards, Mr Edwards
6 rearranged it slightly, with the Competition Act in
7 mind, he then sends it around to Boarer, Edwards,
8 Holton, Boarer then sends it to Henderson. So quite
9 a lot of people have seen this document and quite a lot
10 of people should have had it on their memories and so
11 forth. It is not available. It hasn't been disclosed,
12 and we have asked several times. I have to make sure
13 I'm not being misunderstood here. I have not the
14 slightest comment about the thoroughness with which
15 research has been conducted by the solicitors of
16 distinction we have on the other side. I don't need to
17 say that, I hope.

18 But I draw it to your attention, the fact is this is
19 a document which had a very large number of copies, the
20 odds are there was a chain of emails in the last one,
21 and it's not in Boarer's records, it's not in Edwards'
22 records, it's not in Holton's records and it's not in
23 Henderson's records.

24 THE CHAIRMAN: The document at 110, is that the rearranged
25 one or the pre-rearranged, or do you not know?

1 MR SHARPE: I think we can say for our purposes it's the
2 next document we see, it certainly doesn't purport to be
3 the document Mr Edwards sent round the houses. I am
4 just wondering how the document was rearranged, how it
5 was put in order for Competition Act purposes, and why
6 it was sufficiently unimportant to have been kept, not
7 just by one person within the organisation but by all of
8 them, and I am going to leave the point there because
9 I think it speaks for itself.

10 MR LANDERS: Mr Sharpe, the PS on this email, what does that
11 mean, the rights to the water?

12 MR SHARPE: Let's have a look. (Pause). I took it to mean
13 that he is questioning the very basis of having to part
14 with the water:

15 "If we own the rights to the water, why are we even
16 thinking of giving it to them?"

17 Not realising perhaps that he had an obligation to
18 grant bulk supply and ultimately common carriage. There
19 may be an issue as to what you mean by rights, because
20 if -- I don't know, but if he is talking about: are we,
21 Welsh Water, surrendering our rights to the water as
22 opposed to recognising we don't have the demand for the
23 water and therefore will take less, then there are two
24 ways of looking at it. It must be said that sometimes
25 the evidence swings one way or the other.

1 The rights we are talking about aren't abstraction
2 rights, they are rights under the Heronbridge Agreement.
3 We see that Jackie Boarer agrees with the last point:

4 "I have mentioned this one too, can we use it
5 somewhere else?"

6 We will see perhaps the odd reference to how it has
7 been used elsewhere. Sometimes there is a sort of
8 elision between exercising rights about maintaining the
9 agreement and not renegotiating it, and the other one
10 saying: actually we are going to take the water whether
11 or not we need it, and in which case you,
12 United Utilities can't give it away because there isn't
13 enough water to go round, or distribution capacity. We
14 will come to know to that, I guess, in due course.

15 So we do have, to go back now to the last paper at
16 tab 110. Now, again I am going to have a word with
17 Mr Edwards about this when the time comes. It follows
18 the same methodology as that proposed by Mr Henderson,
19 that is to say it calculates potable distribution costs
20 and adding a non-potable treatment charge. So it starts
21 off, once again, with the large industrial user potable
22 tariff as the basis for its calculation, but this time
23 it assumes water resource costs of only 4p per cubic
24 metre, which of course was the water resource costs
25 broadly between 3p and 4p that Welsh Water were itself

1 paying United Utilities.

2 You can find that at page 801. Instead of making
3 the earlier assumptions that 12p and 21p respectively,
4 we are now down to 4p. You see that also the multiplier
5 of 30 per cent to convert full treatment to non-potable
6 price. You might note the extra sentence at the top of
7 the page at 801:

8 "This calculation method, 30 per cent, although
9 accepted by Ofwat, will come under increasing pressure
10 from Albion."

11 Too true. But it's worth noting what's meant by
12 "accepted" here. This was the figure that Welsh Water
13 gave Ofwat in 1996 leading up to the "minded to"
14 decision, which unfortunately was not subjected to any
15 verification or detailed analysis by Ofwat. As the
16 record shows, when it was actually looked at, the figure
17 of 30 per cent was halved, when Welsh Water did
18 ultimately in 2002 subject the proper costs of the
19 treatment of non-potable water to analysis. I'll come
20 on to that.

21 So this is a document which went to the LCE, the
22 Licence Company Executive. It's worth glancing back now
23 at page 799 to other features of the document, and in
24 particular over the page at page 800, we see here on the
25 part of Mr Holton fairly clear understanding of the

1 Competition Act implications, and the Act coming into
2 force, the Network Access Charge, and the requirement to
3 behave in accordance with the NAC and discuss the
4 feasibility of the application and move without undue
5 delay to negotiation which is being done, both Ofwat and
6 Albion have commented on this. What he meant by
7 commented was protest and complain that the whole
8 process had taken far too long.

9 We see at the bottom "Pricing":

10 "DC's current position on common carriage prices use
11 the whole company averages. Albion don't believe this
12 is an appropriate method ... demanding de-averaged
13 prices, local prices. Albion is saying that DC has
14 already de-averaged with other special agreement
15 customers such as Corus."

16 That with the benefit of hindsight is entirely
17 accurate, given what we know about the 14p per megalitre
18 that Corus was being charged.

19 Now, on page 801 again, you will see in the table,
20 the one that begins "Resources", you will see a figure
21 where on the right-hand column treatment, bulk
22 distribution and treatment are calculated, are expressed
23 rather, where properly a figure for resources is
24 deducted because Albion is getting its water from, by
25 hypothesis, United Utilities. We see a figure pence per

1 cubic metre of 19.94. You will see the figure of
2 treatment is the figure of bulk potable treatment on the
3 left 29.48, multiply that by 30 per cent, and I hope you
4 get a figure of 8.84.

5 So we get a figure of 19.94, and there is nothing in
6 this document to suggest this document went to this
7 committee and the committee is charged with regulatory
8 matters, to say that this is a first shot, a preliminary
9 estimate, an estimate, this is the product of some
10 serious work and this is our methodology, averaging,
11 these are the costs, and this is it, and it arrives at
12 a figure of 19.94.

13 It's worth noting, before we move on, that the
14 multiplier of 30 per cent which is going to come under
15 increasing pressure is "calculated from talking to
16 operational managers and asset managers at the time that
17 the initial Shotton water agreement in 1996 was
18 negotiated". Do you see? On page 801. Then it says:

19 "Work is currently being carried out to produce
20 a robust asset value based on the price for non-potable
21 portion of the treatment price."

22 The clearest possible admission this was not
23 a robust figure, and that proved to be entirely
24 accurate, it was an overestimate by 100 per cent, but
25 they nevertheless know it was flaky yet still carried on

1 with it.

2 That price of 19.94 was considered and approved by
3 the Welsh Water board, or rather considered by the
4 Welsh Water board. You will see that at bundle 4,
5 tab 112. This was considered here to be a progress
6 report. It's just a short semiparagraph, page 811. As
7 I said, this was a minute of the Welsh Water board:

8 "Minutes of a meeting, board of directors, held on
9 Monday, 15 January."

10 You will see again Mr Brooker in attendance,
11 Mr Williams, and over the page "Business Matters", 6.3:

12 "The content of the progress report was noted. The
13 issue of de-averaging of costs of supply remains
14 a complex issue."

15 Yes, I think we are all beginning to agree with
16 that. The intriguing point is "it was plainly discussed
17 that there is a big divide between us, we are going down
18 the average route and it's pretty clear that Albion take
19 a strong view against it". Well, we will see.

20 THE CHAIRMAN: This is still talking about the de-averaging
21 of costs, whereas what Mr Landers pointed out we are
22 talking about in tab 110 is the de-averaging of the
23 price, that's why it seems to me important for us to
24 understand whether that price that they start with is
25 a regulated cost based price or whether it's

1 an unregulated price.

2 MR SHARPE: Water then and now is regulated by Ofwat, and
3 Ofwat is charged to look at a whole basket of varies
4 prices, potable, I think non-potable -- just potable
5 water, and it then sets for a five-year period a profile
6 of permitted price changes by reference to the RPI, and
7 it proves what's called the K factor. The K can be plus
8 or minus and sometimes it's negative and sometimes it is
9 positive and at the beginning of the regulatory period
10 there's going to be P0 adjustment, so if efficiencies
11 have gone very well, they can enjoy them for five years
12 and then they step down and it becomes cost related.

13 What we have here is the LIT tariff, which is not so
14 much regulated of itself but forms part of the basket of
15 all Welsh Water services which fall to be regulated. So
16 it gets a weighting, is my understanding, in the basket.
17 I am looking for a correction and inspiration from those
18 behind me.

19 It is correct weighting I can't give you. So
20 I think the formal analysis is: yes, it is subject to
21 regulation but that regulation is indirect, indirect
22 insofar as it forms part of a much larger bundle --
23 basket it's sometimes called -- of services which are
24 themselves subject to analysis by Ofwat and given
25 a weighting and it's the overall basket, which of course

1 means that within any periodic review the company is
2 free to adjust charges, some go up, some go down. That
3 is a sort of potted and probably overeconomic analysis.

4 I think the fundamental point, which if I may tease
5 it out, this is how Welsh Water decided to do it. They
6 found this large industrial tariff, so that's there, it
7 doesn't really matter -- for potable water -- if it was
8 regulated or not, it was just a number, and then they
9 decided to take that as the sort of core metric and then
10 make certain deductions to arrive at a figure for
11 average non-potable prices, what we are discussing here.

12 It's quite an heroic thing to have done, because
13 it's chalk and cheese: potable, non-potable, very
14 different; distribution costs are very different;
15 treatment costs --

16 THE CHAIRMAN: The difference of them doesn't matter if they
17 make adequate adjustments to that price. I think the
18 point that we are trying to tease out, I don't want to
19 take up too much time on it, is that we have all been
20 talking about an assessment of the costs and
21 de-averaging the costs, and what it seems to be
22 de-averaging is in fact the price, and I am not clear at
23 the moment -- and it may become clear over the next ten
24 days or it may not -- as to whether that was actually
25 a different exercise from the exercise that I thought

1 they were doing, which is working out what the costs of
2 potable supply were, and deducting unused elements of
3 that to arrive at the common carriage price, or whether
4 they were starting with the price and deducting chunks
5 of that to arrive at the common carriage price. Because
6 I think when you then move to looking at actual costs,
7 you are looking at the costs and building up a picture
8 of cost to arrive at a price, not starting with another
9 price and chopping off chunks of that, and those seem to
10 me possibly to be very different exercises.

11 MR SHARPE: Well, I'm not sure the division is quite as
12 stark as you suggest, because at the end of the day,
13 they were attempting to establish a price to Albion for
14 the service of common carriage. How they were deriving
15 that price is the second order of issue, whether they
16 take it from prices or the charges they adopted.
17 I think as you said earlier, respectfully, it really
18 ought not to matter, because -- well, whether one looks
19 at it globally through large scale averages, top-down,
20 or bottom-up by looking at actual charges, as indeed
21 the Tribunal itself did, it ought to have been the same
22 or broadly the same. Of course, it goes without saying
23 providing the right adjustments are made.

24 Of course, here the objective I hope is becoming
25 more and more transparent, they had to get net and 26p.

1 When we got to this stage at 19.94, by this time
2 Ofwat and Albion were banging on the door, really
3 wanting to get the number, so it was rounded up to 20p
4 and issued to Albion as an indicative price in
5 January 2001.

6 You will see by a simple deduction that it is not
7 a figure that's going to be readily neutral from
8 Welsh Water's perspective. Taking account of the saving
9 for water, it still meant that Welsh Water would be 3p
10 per cubic metre worse off than it was under the bulk
11 supply agreement, 26p. That was quite a significant sum
12 of money at stake in relation to Shotton Paper's volume.
13 It would have meant that if Albion had been able to
14 obtain the same water supply price as Welsh Water from
15 United Utilities, roughly 3p per cubic metre, then
16 Albion would have a margin of 3p per cubic metre profit,
17 profit, the basis to win business and retain it. That
18 would show that competition through Welsh Water's
19 network would be viable, opening the door of course for
20 Albion to become a more robust competitor, both in
21 relation to Shotton but actually elsewhere as well, not
22 least Corus.

23 Now, against this background, as I have said,
24 Welsh Water refused to develop any methodology, for
25 various reasons, quote, against the indicative access

1 price. But then, not happy with that, they started to
2 modify the methodology. Albion will contend that the
3 basis of this subsequent refinement was to generate the
4 kind of method which would produce revenue neutrality,
5 to creep them up further and further to the point where
6 Albion had no oxygen, essentially, to compete.

7 It appears that Mr Edwards -- I am going to take you
8 to bundle 4, tab 123 -- it's pretty clear was aware of
9 the problems here. So he came up with the idea of
10 adapting the methodology of Messrs Henderson and Holton,
11 and using something he called whole company averages.
12 Specifically this involved calculating whole company
13 average treatment cost, and that's at page 861.

14 Before we do that, and this is a complicated email
15 which is going to require quite a bit of explanation
16 from Mr Edwards, he has taken as the starting point the
17 whole company average cost of water, 75.43, and he is
18 taking all the water sold, he split the resourcing
19 treatment and distribution as per the regulatory
20 accounts, so those are the accounts that go to Ofwat,
21 and then he split it as per Tony Evans, and I confess to
22 you I haven't a clue who Tony Evans is and what "as per"
23 means. No doubt Mr Edwards will explain. Then he has
24 taken the top band, large industrial tariff, right, plus
25 bulk distribution, and then he has obtained the bulk

1 distribution charges, resources and tariff from one, he
2 has taken away three. Those are 1999 costs. All right:

3 "My thoughts absent any modelling here is that this
4 approach is consistent with companies' submissions
5 already approved by Ofwat ..."

6 That can really only refer to 1996.

7 "... and the only challenge can be over the
8 30 per cent treatment figure which they have also
9 approved."

10 That too can only refer to 1996. You saw the letter
11 this morning from Ofwat, there was no approval there,
12 this wasn't any dissent either, but equally there was no
13 data, and you now know that that 30 per cent figure was
14 the product of chats with managers, it wasn't
15 an analysis of the cost. Do you recall? A few moments
16 ago we asked around.

17 So he starts off with the average cost of treating
18 all volumes of water delivered by Welsh Water, now, this
19 must include raw water, and cost of treating the raw
20 water is zero. Partially treated water. Now, the cost
21 there relates only, as you know, to three customers.
22 And fully treated water.

23 So the whole company average inevitably gives
24 a lower treatment cost since, as I think you pointed out
25 a moment ago, this included raw water and partially

1 treated water. It might seem odd to you that
2 Welsh Water were trying to calculate lower treatment
3 costs. However, because Welsh Water were calculating
4 the bulk potable distribution cost as a residual item by
5 taking away the treatment, that would have the effect of
6 increasing the cost of bulk distribution.

7 Calculating the bulk potable distribution cost by
8 deducting the treatment cost as well as the resource
9 cost. So if the resource cost is constant and you
10 reduce the treatment cost, then you increase the
11 residual bulk distribution, therefore the higher the
12 calculated bulk potable distribution cost would be.

13 As a result Welsh Water were able to increase the
14 calculated potable distribution cost by no less than
15 45 per cent from 11p using the indicative access price
16 to 16p. It then uses the same 30 per cent percentage
17 which the LCE 001 document had noted was not robust, and
18 I hope you recall that, in order to calculate
19 a non-potable treatment cost.

20 So as a result of the reduction in the treatment
21 cost, this reduced the calculated non-potable treatment
22 somewhat to 7.2p but it doesn't really matter. However,
23 because the deemed potable distribution cost had
24 increased so much, the end result was a much higher
25 common carriage price. That now came to 23.2p per cubic

1 metre.

2 You will immediately see by adding reasonable cost
3 of water resources was going to tip the balance over 26,
4 so ensured that Albion's common carriage application
5 wouldn't be commercially viable since there was no
6 prospect of United Utilities offering less than they
7 were charging Welsh Water, the opposite. At this point
8 one is tempted to say internally "job done", because
9 this had now at least arrived at a figure for common
10 carriage, using some of the imagination displayed
11 ultimately by Mr Edwards who arrived at a figure of
12 23.2.

13 Actually the mystery doesn't quite end there, 23.2
14 disappears and in the next document -- sorry. What
15 happens next? A paper was prepared, which you will find
16 at tab 121 of bundle 4. This goes to the LCE, it's
17 written by Messrs Holton and Edwards. It records, as
18 you see, that the ... it explains, first of all, the
19 background, the argument, scheme of charges. At 5.2 you
20 see the calculation has now been revisited from the
21 indicative price offered some weeks before, and a firm
22 price has been calculated.

23 Dr Bryan took "firm" literally, and took it to mean
24 this is their offer. Mr Holton told Ofwat on 9 February
25 that if you are getting board approval for the price, it

1 would then be issued to Albion. For your note, that's
2 bundle 4, tab 127. It's also clear that Mr Edwards told
3 Ofwat on 15 February that agreement on the access price
4 had been reached at the Welsh Water board meeting. For
5 your note, that's bundle 4, tab 128.

6 Unfortunately Welsh Water has failed to produce any
7 minutes of any board meeting at which that approval was
8 discussed or given, and Mr Williams, who is giving
9 evidence, cannot recall whether it was discussed by the
10 Welsh Water board or even if he attended.

11 Given the matter had gone to the November board, it
12 was apparently scheduled, according to Mr Edwards, for
13 the December board. It was plainly discussed at the
14 January board. The obvious fact that common carriage
15 was of some considerable financial and policy
16 importance, it seems a safe assumption that it was
17 discussed and approved by the board in February. This
18 is, after all, what Welsh Water told Ofwat, they had no
19 reason to disbelieve them, and it is a pity that the
20 approval process was not available or minuted in
21 a way -- or minuted.

22 Key point, of course, is that final price, 23.2, was
23 based upon bulk potable distribution, an entirely and
24 much more expensive service than the one which Albion
25 was requesting. It's actually quite a bizarre way of

1 approaching this calculation. Secondly, it assumed that
2 all non-potable treatment was costed at 30 per cent of
3 bulk potable treatment, in circumstances in which it
4 ought to have been known to Welsh Water. They knew it
5 was not robust, that's the first point. But secondly,
6 they must have had a notion that taking a multiple of
7 30 per cent of very expensive bulk potable treatment and
8 just applying that, and then kidding themselves that
9 this had the approval of Ofwat, when Ofwat plainly
10 didn't consider it, was not isolated in their "minded
11 to" letter which I have taken you to.

12 We now know when it was subjected to greater
13 analysis it was halved down to sort of 30 per cent,
14 15 per cent, one-sixth, which had the effect of course
15 of halving the cost.

16 Anyway, now, that's the common carriage history,
17 leading up to the price. It's not quite over, I am
18 afraid, because Albion didn't get this price at all at
19 that time. It was sent to Ofwat. It was only sent to
20 Ofwat, and you will see that at -- I'll give it to you
21 for your reference -- bundle 4/132, and there was no
22 immediate intention to send it to Albion, and it was
23 only Ofwat saying "What on earth are you doing? I have
24 asked you to send this to Albion, this is not our
25 problem, it's your relationship with Albion, and so go

1 away and send it to them. It took Ofwat's requirement
2 on Welsh Water to get that settled. As you know, at
3 that point, shortly afterwards, within a week, having
4 recognised that Welsh Water weren't in a position to
5 negotiate, having been presented with a firm price,
6 Albion made its complaint to Ofwat.

7 I wonder if that might be a convenient moment to
8 allow our sturdy stenographers a moment of respite?

9 I do have a chunk to go.

10 THE CHAIRMAN: We will take five minutes and come back at 25
11 past 3.

12 (3.20 pm)

13 (A short break)

14 (3.25 pm)

15 MR SHARPE: Now, I am going to turn to the other side of the
16 stage, the relationship between Albion and
17 United Utilities.

18 Madam, I am likely to be, I would put it like this,
19 no less than one hour, and I should hope -- well, if
20 I exceed that, it's because of imponderables. You will
21 not want me to go across until tomorrow morning, will
22 you? I'm in your hands.

23 THE CHAIRMAN: No, I would prefer you not to go across until
24 tomorrow morning.

25 MR SHARPE: I know that Mr Beard won't be with us tomorrow

1 morning.

2 Right, so we will going to the other side of the
3 stage. I left off the story, United Utilities had
4 agreed that it was in principle willing to sell Albion
5 raw water from the Heronbridge extraction point. Albion
6 made a formal application to United on 8 March 2000.
7 For your note only, bundle 3, tab 46. It had raised
8 this matter informally as early as 20 May 1999, for
9 your note, bundle 2, tab 23.

10 Now, the terms of the application, which I am not
11 going to take you to, are interesting for one respect,
12 they were seeking access to what they regarded as
13 an essential facility by virtue of United Utilities'
14 dominant position, and the Tribunal will understand
15 that's the language of competition law and that's how it
16 was couched. The Act itself had come into force eight
17 days before.

18 United responded in a letter on 15 March 2000,
19 bundle 3, tab 50, proposing a meeting. By August 2000,
20 Dr Bryan was reporting to his board, bundle 3, tab 60,
21 that United were offering a bulk supply price of 8p per
22 cubic metre, along with a benefit sharing arrangement
23 that Dr Bryan estimated would be worth £240,000 to
24 Albion.

25 Those negotiations did not proceed particularly

1 quickly after that. Matters had stalled, as Dr Bryan
2 reported to Albion's board in November 2000, again
3 bundle 3, tab 70.

4 Matters had stalled, Albion was awaiting a response
5 from Welsh Water relating to common carriage, so it was
6 putting the common carriage horse before the bulk supply
7 cart.

8 In November 2000 United had provided Albion with
9 draft heads of terms, that's at bundle 3, tab 77, which
10 I think I must take you to. Bundle 3, tab 77. My
11 instructions are this is a document that emanated from
12 United Utilities. It has all the makings of a draft
13 contract, places for the signature, governing law,
14 dispute resolution and so forth. I will take you so
15 elements of it reasonably quickly. First of all ignore
16 the footer, I think that is when it was printed, this
17 copy, but I am instructed it's 8 November 2000. I am
18 going to draw your attention to just a few points.

19 1, background, simply deals with the supply
20 obligations. 1.8 is relevant:

21 "North West undertakes that it will enter into
22 negotiations with DCC with a view to varying in favour
23 of NWW [North West Water] the financial provisions of
24 the agreement between North West Water and Welsh Water,
25 dated 10 May, referred to in clause 1.2 hereof."

1 It's a curious provision, that it's indicative of
2 a serious intent on the part of United to renegotiate
3 their agreement, quite what they expected Albion to do
4 in that context is not known, and no doubt Dr Bryan may
5 help, but he may not. We know, if you turn immediately
6 to page 692, and we look at the financial relationship,
7 North West will pay Albion the following development
8 fees, that if that Heronbridge Agreement had been
9 varied, as between Welsh Water and United Utilities,
10 Albion would get £25,000.

11 We will come on to that in a moment. The actual
12 price is not agreed and it's not expressed in this
13 agreement. The financial relationships deal with these
14 other matters. You will see in 9.1, especially at (c)
15 and (d), provision for the sharing of the benefits that
16 might accrue resulting from this agreement. So if, for
17 example, a higher price had been negotiated with Welsh
18 Water, an element of that, and we see it divides into
19 two parts, 50 per cent for the first six months and
20 30 per cent for the 12 months following, 18 months in
21 all, elements of that would accrue to Albion and to
22 United.

23 THE CHAIRMAN: So is the effect of that, broadly speaking,
24 that if they had succeeded in increasing the price that
25 Dwr Cymru pays to United Utilities under the Heronbridge

1 Agreement, first Albion would get the £25,000, and then
2 it would get effectively half of the additional monies
3 that United Utilities was earning because of that uplift
4 in what DC were paying?

5 MR SHARPE: Yes. It's also the case that if Welsh Water had
6 decided to maintain their agreement unnegotiated and
7 continued to pay pence per cubic metre to
8 United Utilities, that too would fall within the general
9 heading of (c) and (d), because that would represent
10 an increase in income they would receive from DC to the
11 agreement between -- if the agreement between North West
12 and Albion had not been entered into.

13 Insofar as their revenue was maintained from Welsh
14 Water, even though Welsh Water was not physically taking
15 the water under the Heronbridge Agreement, they would
16 then be getting revenue from Welsh Water but then, in
17 addition, would be getting revenue from Albion. Looking
18 at the construction of this term in the agreement, one
19 sees that the surplus over and above the revenue they
20 were receiving from Welsh Water would be for these time
21 periods divided between the two parties.

22 THE CHAIRMAN: All right.

23 MR SHARPE: Which of course would have had the effect of
24 reducing the effective cost per cubic metre of water to
25 Albion, but let's say for argument's sake if a provision

1 of 9p per cubic metre had been negotiated, which is not
2 the case, and if Welsh Water maintained -- as they now
3 insist they would have maintained -- the Heronbridge
4 Agreement unnegotiated, that they continued to pay
5 whatever, let's say 3p, or 6p or whatever it is, they
6 would receive 3p as per the Heronbridge Agreement, but
7 in addition would be receiving revenue from Albion.
8 Under the terms of this draft, if it can be put into
9 effect, half of that increment paid by Albion would be
10 returned to Albion, so reducing effectively the cost.

11 MR LANDERS: Can I just make sure I've understood that? So
12 what you are saying is that if the agreement was not
13 renegotiated and Albion bought money from
14 United Utilities, so United Utilities would get the
15 money from the sale of Albion, but in addition then
16 Dwr Cymru would be obliged to carry on paying 3p less
17 the 0.7 for electricity for the water it was no longer
18 receiving up to the cap?

19 MR SHARPE: Yes. That's exactly right. The increment to
20 revenue would be the payment --

21 MR LANDERS: Then they would split that additional --

22 MR SHARPE: Yes. That's the consequence, of course, of
23 Welsh Water's position that they wouldn't have
24 negotiated the agreement if common carriage had been put
25 into effect.

1 So they would be paying for water but not receiving
2 it. One can understand that position from a commercial
3 basis, because they wanted to have another go at Shotton
4 at some time in the future, although the Shotton
5 agreement, I should have taken you to this, the duration
6 of that was over ten years.

7 Anyway, I think that's all I wanted to do in
8 relation to this draft agreement.

9 Then we turn to tab 89, and this is a letter from
10 Mr Lees dated 20 November. The purport of this
11 letter -- and I'll summarise it, because I am somewhat
12 pressed for time -- is that United made it clear that it
13 couldn't consider it lawful to charge Albion and Welsh
14 Water different prices. This essentially was
15 an invitation to Welsh Water to increase the price, to
16 bring it in line with a higher price likely to be
17 charged to Albion, and you pick it up on page 713:

18 "This would appear to be an opportune moment to
19 update the Heronbridge Agreement so that the terms and
20 conditions set out in the agreement with Albion and the
21 terms and conditions agreed with DCC can be seen to be
22 competitive and within the spirit of section 40."

23 I will come on to that.

24 "Many would expect the agreements to be mirror
25 images."

1 We will come back to that, but you will see all too
2 transparently what United wanted and that was to have
3 equality of price but of a higher price than the
4 Heronbridge Agreement cost reflective price.

5 There then followed a tripartite meeting between
6 United, Welsh and Albion on 16 January 2001, and that
7 addressed essentially the practical issues of supply.
8 You will find this at bundle 4, tab 111, to which I am
9 not going to take you, but it was at this meeting that
10 United indicated that its proposed water price "would
11 not exceed 9p per cubic metre".

12 So that was the position in January, but in early
13 February, Albion had heard informally that United was
14 considering a price of 12.1p per cubic metre, to be
15 charged by United to Albion. Albion immediately
16 responded to the United Utilities, telling them this
17 would be an unlawful price, very much along the lines
18 that it would be improper and inappropriate for you,
19 United, to discriminate between Welsh Water at its low
20 price and Albion priced at approximately twice, three
21 times what Welsh Water were paying. Of course
22 sentiments which United were, unknown to Albion,
23 expressing to Welsh Water, that is to say the price
24 should be the same, except United Utilities wanted
25 a higher price and Albion wanted a lower price, or

1 an equal price.

2 But certainly the 12.1p figure was said to be the
3 product of a long run marginal cost calculation, but
4 this long run marginal cost calculation proved to be
5 very short run, because it was virtually immediately
6 reduced back to 9p, but on terms of the draft agreement,
7 which included the benefit sharing provisions, and
8 a caveat that Albion would have to agree that this was
9 a fair and reasonable price. Why is that latter point
10 significant? Because they were well aware, well aware,
11 that Albion had the right to go to Ofwat to seek
12 a renegotiation of the price under section 40A, to which
13 I am going to turn in a minute.

14 What they wanted to do, it's doubtful actually
15 whether a simple declaration that it is fair and
16 reasonable would have been enough for Ofwat, but it was
17 certainly something worth going for as far as United was
18 concerned, and certainly the sentiments there are all
19 too transparent.

20 Of course by this time, the supply agreement with
21 United probably seemed less important to Albion, given
22 that by this time Albion had already received a very
23 high indicative common carriage price, the 20p figure,
24 but in any event, pursuant to the 12.1p, Dr Bryan wanted
25 a breakdown, as always he wanted to say: how did you

1 arrive at this number?

2 United responded to that email on 1 March, which
3 I am not going to take you to at the moment, but failed
4 to provide any detail of how they arrived at
5 12.1 per cent, if it was long run marginal cost, it's
6 relatively easy to, if you based it on some calculations
7 at least, to show them, nothing commercially
8 confidential, hard to see Albion as a major competitor
9 with United Utilities and in fact no justification was
10 given.

11 Anyway, after receiving the abusive FAP, there was
12 not much point in pursuing negotiations with United
13 unless and until a proper common carriage price was
14 offered. No doubt Dr Bryan will elaborate on that if
15 asked.

16 In terms of events after the FAP, there are a small
17 number of events that I need to address in this opening.
18 First of all, the section 26 notice. You remember
19 I mentioned it this morning. Section 26 is the
20 statutory power of Ofwat to demand papers, documents,
21 minutes and everything else. You will find this at
22 bundle 4, page 154.

23 Now, here we see a request to Mr Brooker,
24 29 June 2001. It's a very formal document, as you see.
25 You may well be aware that this is a penal document. If

1 parties tell lies, they go to jail. I am told that's
2 an exaggeration. They can do. You will find that at
3 the end "Offences". So people take these things very,
4 very seriously, as I think everybody knows here.

5 Let me draw your attention on the first page,
6 criminal proceedings; on the second, at page 957,
7 request 1:

8 "Please provide copies of all documents ..."

9 Do you see?

10 "... including without limitation notes of internal
11 meetings including board meetings, other internal
12 documents ... relating to the access price and the terms
13 and conditions."

14 Now, that date, June 2001, it's a very important
15 request in the context of the present proceedings.
16 I presume, and indeed I think know, that Welsh Water
17 would have collected together all the documents in its
18 possession relating to the Albion common carriage matter
19 and sent copies of those to Ofwat ten years ago. But
20 I have already commented on a number of really quite
21 startling omissions in the documentary record now
22 available and I warned you -- fair warning -- in the
23 course of the cross-examination there will be more
24 unexplained documents which are referred to which, on
25 the face of it, look rather important. People doing

1 work, it would seem, on local costs and other
2 calculations that sort of disappears. Consultancy
3 reports which disappear.

4 THE CHAIRMAN: Disappear in the sense that they were
5 disclosed to Ofwat in response to this notice?

6 MR SHARPE: No, I can't say that because I have not seen
7 what was given to Ofwat and --

8 THE CHAIRMAN: You never had access to the Ofwat file?

9 MR SHARPE: No. It would have been open, of course, to
10 Welsh Water to have made a request of Ofwat. No doubt
11 Welsh Water has its own documents. I can't say whether
12 everything we have seen went to Ofwat. I can't say
13 that, it's not in the evidence. I would hope so.
14 I have no reason to doubt that it didn't.

15 THE CHAIRMAN: That's not the question I am asking, I am
16 asking the other way around: is there material -- we
17 don't know whether there is material that went to Ofwat
18 in response to this which we have not seen.

19 MR SHARPE: I don't know.

20 MR BEARD: Ofwat provided all that it thought was relevant
21 to Albion of the documents that were enclosed in the
22 section 26 notice, so I am not quite sure where
23 Mr Sharpe is going with this. This is one of the
24 concerns we have about these allegations about --

25 THE CHAIRMAN: I don't think he can go anywhere with it,

1 because, as he said, he doesn't know.

2 MR BEARD: I am perfectly content with him not going
3 anywhere with it, it's when he starts trying to go
4 somewhere with it that I get concerned.

5 MR SHARPE: I am sorry if my friend is concerned.

6 THE CHAIRMAN: Let's leave it on the basis: you don't know
7 precisely what went to Ofwat under cover of this, in
8 response to this section 26 notice.

9 MR SHARPE: We got some material in 2004, but whether that
10 was identical with what went to Ofwat we don't know.
11 That's my understanding.

12 Anyway, I will leave it there. None of that
13 detracts from the point that they must have had all the
14 documents in several boxes which could readily have been
15 made available in any time period, some of it has
16 dribbled out, we are not entirely sure whether all of it
17 has dribbled out.

18 Anyway, the next request to which I draw your
19 attention is request 14, which you will find at
20 page 960:

21 "...want a breakdown of the actual costs incurred by
22 Welsh Water in providing the service."

23 If we go over the page, we have seen this, I think,
24 we have D21. This is Welsh Water's response to Ofwat's
25 question at paragraph 14.

1 The first point, of course, is that Welsh Water does
2 not seem to have disclosed either the local accounting
3 costs or the local asset register for the
4 Ashgrove System. Ofwat are very clear, they wanted
5 disclosure of the actual costs, and it would seem, in my
6 respectful submission, that their failure to provide
7 local accounting costs or the local asset register,
8 which subsequently became available, I believe in 2006.
9 So that's the first point.

10 The second point is that Welsh Water puts forward
11 the original 1996 calculation as still being accurate
12 and suggests that taking account of inflation, the local
13 cost would be closer to 20p per cubic metre for common
14 carriage. That's described as equating reasonably with
15 the combined access price currently offered to Albion.

16 Now, the 1996 calculation, as I have pointed out to
17 you and as you have seen in Dr Bryan's evidence,
18 consists of really significantly inflated fictional
19 numbers. It's not merely my judgment they are
20 fictional, they are fictional in the light of subsequent
21 analysis by Welsh Water itself, major, major
22 retrospective -- major adjustments, none of which are
23 retrospective, and I have already alluded to one of the
24 most egregious of those which is the management
25 on-costs.

1 Now, I mentioned that United had made two attempts
2 to have Ofwat vary the terms of the Heronbridge
3 Agreement pursuant to section 40A of the
4 Water Industry Act. I want to take you to those,
5 because they reveal some quite important features about
6 United's attitude to pricing. Before that, let me take
7 you to the Act or one page of the Act, which you will
8 find at bundle 14, tab 33. Can we pick it up at
9 page 5065? This is the statutory machinery which
10 I alluded to earlier which was in force, and my friend
11 very helpfully indicated it came into force with the
12 Competition and Services (Utilities) Act 1992.

13 What section 40A does is permits a request of
14 a party to an agreement to vary or terminate a bulk
15 supply agreement. Can we pick it up at 40A(i):

16 "This section applies where on the application of
17 any party to a bulk supply agreement it appears to the
18 director that it is necessary or expedient for the
19 purpose of securing the efficient use of water resources
20 or the efficient supply of water to vary the agreement
21 or to terminate it."

22 So that's the precondition for the exercise of these
23 powers by the director, and the director then, in
24 subsection (ii):

25 " ... may vary the agreement both as to term and

1 varying any of the terms or conditions to which
2 supply is to be given."

3 So you see the pre-conditions are that you have to
4 be satisfied that the water resources are necessary or
5 expedient.

6 When we look at 40A(vii):

7 "In exercising these functions under this section,
8 the director shall have regard to the expenses incurred
9 by the supplier in complying with its obligations under
10 the bulk supply agreement and then to the desirability
11 of facilitating effective competition, recovering the
12 expenses of complying with its obligations", and those
13 are the two that I think I particularly want to draw
14 your attention to.

15 So it's a very useful statutory procedure.

16 Now, the application, the first application you will
17 find at bundle 4, tab 165.

18 THE CHAIRMAN: Just wait one moment. (Pause). Yes.

19 MR SHARPE: Now, there are two applications sequentially.

20 I think in the interests of time I will take you to one.
21 I don't think there is anything ... now, if we look at
22 it at 1032, I am taking you now to bundle 4, tab 165,
23 you will see at 1032 a cover letter from United to the
24 managing director of United Utilities telling him what
25 they are planning to do.

1 The next page is essentially history, and of no
2 particular relevance or novelty to us at this stage.

3 If you go on to the third page:

4 "The agreement provides any of the above clauses may
5 be varied by the written agreement."

6 But there is nothing we can do if the parties are
7 unable to agree. Then it talks about opening
8 negotiations:

9 "Welsh Water have refused to agree to any variation
10 in the current contract."

11 Then it goes on:

12 "United believes that the current contract
13 conditions due not secure the efficient use of water,
14 potentially discriminatory and anticompetitive."

15 I think the word "potentially" there must allude to
16 the possibility of an agreement with Albion. Then it
17 goes on:

18 "UU has received an approach from Albion
19 requesting bulk supply."

20 It goes on:

21 "In order to provide this supply to Albion, the
22 agreement between ourselves and Welsh Water would need
23 to be varied, variations which they would refuse to
24 agree to."

25 Well, you can see where they are going. They are

1 praying in aid Albion's application for bulk supply.
2 Underneath it is an unwillingness to offer the same
3 price as Welsh Water, and they are using it as a lever
4 to prise up the price. Here having failed in
5 negotiation, they are trying to ask the Regulator to do
6 it for them, and they are bringing in
7 a non-discrimination competition provisions.

8 If we go over to the next tab, we see not the cover
9 but the application itself. Pick it up at page 1039 at
10 the bottom:

11 "The current agreement provides a reimbursement of
12 costs incurred. UU doesn't previous this is
13 appropriate. The effective price fails to ensure
14 efficient use of water and restricts potential
15 competitive entry. The proposed price is 12.1. The
16 price is supported by the estimated regional LMRC of
17 this element of the supply chain."

18 Over the page:

19 "The current price is significantly below Long Run
20 Margin of Cost and as such may conflict with Ofwat's
21 guidelines and the application of the Competition Act.
22 United Utilities would intend to supply [and this is
23 important] both Welsh Water and Albion Water at the same
24 price in order to comply with licence condition E, which
25 is a non-discrimination provision in the licence and the

1 Competition Act."

2 I am not going to dwell on condition E because there
3 is a big issue there which I don't think is an issue for
4 us, but certainly they are arguing and the
5 Competition Act 1998, so they want a price of 12p plus
6 an annual adjustment.

7 Now, this is the same thing a year later. Neither
8 of these applications suggested the Heronbridge
9 Agreement was not cost reflective. I think we have seen
10 enough to say that's really United Utilities' view.
11 Quite what Ms White is saying to the contrary is
12 something no doubt she will explain to us next week.

13 Nor, incidentally, can it be the case that they were
14 losing money on the agreement, because as you saw that's
15 one of the provisions in section 40 subsection (vii),
16 were they recovering making a reasonable return, and
17 I think we are entitled to infer that if they had
18 argued, and they don't, that they were losing one in
19 agreement they would have said so, and if they had said
20 so, it would be one of the considerations which the
21 Regulator would have taken into account as being
22 essentially undesirable. None of those were argued. So
23 let's just assume that it's cost reflective and they
24 were making money, they just wanted to make more money.

25 As Dr Johnson said, a man is seldom more innocently

1 deployed.

2 Anyway, United did not persuade Ofwat, which
3 rejected both applications on the basis that the
4 conditions necessary for it were not satisfied. So it
5 was not necessary or expedient for the purposes of
6 securing the efficient use of water resources or the
7 efficient supply of water to vary the agreement, so it
8 refused to amend the agreement. We see that, for your
9 note only, at bundle 5, tab 120, which is the refusal.
10 Bundle 5/210.

11 In fact, Ofwat recognised that although the
12 section 40A test would not generally be satisfied if the
13 variation of the agreement would simply transfer costs
14 or risks from one company's customers to another, it
15 would be where the supplier was not recovering the
16 expenses of complying with its obligation by virtue of
17 section 40A and was not securing the reasonable rate of
18 return. They put that expressly with the implication if
19 they weren't covering their costs, the position of the
20 out-turn might have been different.

21 So we see that Ofwat considers both that the price
22 in the Heronbridge Agreement was acceptable, and did not
23 justify in the interests of efficiency or expediency any
24 variation when the matter was put to them, not once but
25 twice, but this time by United Utilities, and therefore

1 United couldn't justify an increase in the price.

2 The next matter which I would refer you to is the
3 fact that Albion was asking Welsh Water to reconsider
4 the FAP after it was issued in March 2001. You will see
5 in bundle 4, tab 171, Albion asked Welsh Water for a new
6 access price on 22 March 2002. Welsh Water's response
7 to that is found at bundle 4, tab 174, and that was, as
8 you know, a simple refusal to provide any new price, and
9 stated that while any new price provided would be
10 broadly in line with that already offered, so no joy.

11 July 2003, Albion was approached by Corus to ask
12 whether it was interested in bidding for the supply of
13 water to Corus' three plants, including Corus Shotton.
14 You will see that letter at bundle 5, tab 204. Here we
15 should rely upon Dr Bryan's witness statement, and
16 I will give you the references, paragraphs 201 to 209.
17 Albion wasn't in a position to bid for that supply,
18 given that it had still not managed to obtain a properly
19 cost based offer for common carriage. Perhaps the
20 position is even more strong in relation to Corus
21 because Corus had been offered an even lower price, and
22 you will recall my submissions this morning.

23 This meant that the abusive FAP prevented Albion
24 from competing against Welsh Water as Welsh Water had no
25 doubt hoped and intended. Of course, if a proper access

1 price had been granted, then it follows that Albion
2 would have been in a much stronger position to have
3 responded to Corus, and there is no good reason to think
4 it would not have responded to Corus.

5 THE CHAIRMAN: But how could it have competed against the
6 lower retail price from Welsh Water to Corus?

7 MR SHARPE: It would first of all depend upon the level of
8 common carriage, and secondly, I glossed over, in the
9 interests of time and relevance, that there had been
10 some form of interim arrangements whereby Corus' price
11 was increased as a result of pressure. The sequence was
12 very simple: Albion went to Ofwat and said "Corus are
13 getting a much better deal than Shotton Paper, can we
14 have the same deal for Shotton Paper?" The response was
15 essentially Welsh Water increasing the price to Corus,
16 reducing but not eliminating the differential and
17 attempting to justify the differential by reference to
18 storage and lagoons and the like. I am not going to
19 dwell on the detail.

20 Our case of course in relation to Corus is that our
21 loss as a result of the abuse of the FAP was the loss of
22 a chance. Our view, and Dr Bryan will no doubt give
23 evidence and be questioned on it, he thought he was in
24 with a very good chance of winning over Corus and did
25 the numbers. So because the current common carriage

1 offer was so high, it was not something that they could
2 contemplate even, as we saw earlier, given his capacity
3 and Albion's capacity to take risks. But the risk was
4 too great. So looking at it from the counterfactual,
5 and we looked at the price at that time, if it had that
6 price, he will tell you he would have gone forward with
7 Corus.

8 Right. I should also draw your attention to Welsh
9 Water's Large Industrial User non-potable tariff which
10 Welsh Water issued in 2003. Now, I've several times
11 mentioned this crude apportionment of treatment costs
12 between potable and non-potable. At bundle 5, tab 192
13 we see that they had at last done some work on this
14 seven years after 1996. I hadn't intended to take you
15 to it. They had done some work to calculate treatment
16 cost for partially treated water. I think I can
17 summarise this accurately. Bundle 5, tab 192. I want
18 to go to paragraph 4. You see partial treatment
19 according to them accounted for 15.2 per cent of full
20 treatment given in order to get potable water, giving
21 a partial treatment unit price of only 3.31p per cubic
22 metre.

23 Note this is for the year 2003/4, three years after
24 the FAP price of 7.2p, figure of 7.2p for treatment,
25 non-potable treatment. So it had gone down from 7.2p to

1 3.31, so it's less than 46 per cent of the original
2 cost, despite the passage of time.

3 I have referred a few times to this. This is the
4 adjustment of the non-robust figure, the 30 per cent was
5 the figure they gave Ofwat not once but twice.

6 THE CHAIRMAN: That is a figure for the proportion of
7 treatment to get potable water, that it costs to get
8 non-potable water.

9 MR SHARPE: Perhaps the other way around. It's the
10 percentage represented of the bulk potable treatment
11 costs which you can infer were the costs incurred in --
12 the costs attributable to non-potable water -- partial
13 treatment, rather, of non-potable water --

14 THE CHAIRMAN: Of partially treated, yes.

15 MR SHARPE: -- amounted to 30 per cent of the --

16 THE CHAIRMAN: In other words, it costs, looking at partial
17 treatment, that costs 15.2 per cent of what it costs to
18 treat potable water?

19 MR SHARPE: Exactly. On analysis, whereas the working
20 assumption from 1996 onwards and the assumption that
21 underlay the FAP was 30 per cent, twice as much. So
22 when actually they did the work, I said it's slashed by
23 46 per cent three years later.

24 MR LANDERS: Which sort of non-potable was that? Or was it
25 both sorts? Was that the raw and the partially treated

1 or just the partially treated?

2 MR SHARPE: Just the partially treated. The point about raw
3 is that it really is raw, there is no treatment at all,
4 so it's not a weighting, it's not included in the
5 calculation at all.

6 Now, it's interesting to note here we have the
7 figure which does serve to reduce by 46 per cent, it
8 goes down from 7.2p to 3.31p per cubic metre, that would
9 have been very welcome to Albion in 2003, and it would
10 have been a good opportunity for Welsh Water to have
11 come back and said "Actually, we have done the numbers
12 properly for a change, they are now robust", to use
13 their language, and "Let's think about an adjustment and
14 giving him the margin he was seeking", so we get back to
15 probably below 20.

16 So if they had had any interest at all in ending the
17 effect of the abusive price, then this would have been
18 the point to do so, and they didn't.

19 Now, prompted by a request from Ofwat in
20 January 2004, Welsh Water did indeed send Ofwat but not
21 Albion -- you would have thought they would have
22 learned, the recipients should be Albion, but anyway
23 they sent to Ofwat a price, some indication of price,
24 and this became known as the second access price, and
25 you will find it for your note at bundle 5, tab 217.

1 I think we have to go to this, sorry. Now you see this
2 is a letter from Welsh Water to Ofwat:

3 "Thank you for your letter of 7 January ... wanting
4 access prices for non-potable water ..."

5 And you read it. Welsh Water put some store by
6 this. They say this is yet another offer of a fair
7 access price, and therefore any damages suffered as
8 a result of the first access price should end at this
9 point, because the chain of causation ends at Albion's
10 refusal to accept this.

11 Well, first of all, Albion's position is that this
12 merely states an indicative access price. Albion
13 received this indirectly via Ofwat, but it's just
14 an indicative price. As you see, it says that the
15 treatment price for non-potable water to Albion could
16 be -- could be -- 17.74 per cubic metre. The letter
17 goes on to say:

18 "This price would form the basis of the starting
19 point."

20 So we have the basis of, what, the starting point
21 for a new application and wouldn't include any other
22 administrative and associated costs. In our submission,
23 Welsh Water were making it clear that the figure being
24 given was incomplete and was providing no indication of
25 the additional costs that it thought needed to be added.

1 In terms of additional costs, the Tribunal should bear
2 in Welsh Water had previously told Ofwat that the
3 management on-costs were in excess of 6.2p per cubic
4 metre.

5 So I can put it like this: no offer was made to
6 Albion as such. Secondly, this was a conditional
7 indicative offer. Thirdly, it was made clear that there
8 were other unspecified costs to be added. So it was
9 a long way short of a definite, firm offer that would be
10 sufficient to even begin to be considered to break the
11 chain of causation.

12 Now, if Welsh Water had genuinely wanted to bring
13 the effects of the abuse to an end, then it could have
14 done and should have made Albion an offer of a proper
15 common carriage price based upon the costs that it knew
16 existed at that time, and it didn't. There is nothing
17 in the letter to indicate willingness on the part of
18 Welsh Water to negotiate properly. In our submission,
19 they cannot rely upon this as a cut-off point for the
20 damages claim.

21 Now, you will be relieved to hear I am not going to
22 take you through the years of litigation that followed
23 before the Tribunal in the Court of Appeal. The outcome
24 is of course the reason why we are here. The Tribunal
25 concluded that the FAP involved an unlawful margin

1 squeeze and excessive pricing.

2 Following the Tribunal's excessive pricing judgment
3 of 7 November 2008 [The Unfair Pricing Judgment],
4 Welsh Water made what it described as an indicative
5 access price offer, and this stated that Welsh Water was
6 prepared to offer common carriage to Albion at 14.4p per
7 cubic metre in 2000/2001 prices, adjusted for inflation
8 and subject to contract. You will find that, for your
9 note, at bundle 8, tab 282.

10 Now, this figure was of course an average of the
11 three prices identified in paragraph 197 of the
12 excessive prices judgment [The Unfair Pricing Judgment],
13 and Welsh Water suggested that using that average was
14 fair and reasonable in the circumstances.

15 Now, you will have seen the responses to that, and
16 again for your note only, bundle 8/283 and 284.

17 The first of those references says: can we have
18 a lower offer, please, and made a counteroffer of 12.4p
19 per cubic metre down from 14.4. Now, that letter is
20 heavily relied upon by Welsh Water in these proceedings
21 as showing that Albion would never have accepted even
22 a lawful common carriage price. It's rather an odd
23 argument for them to make, given the following day
24 Albion agreed to a figure of 14.4p per cubic metre as
25 a compromise remedy. It's one thing to say "This is our

1 counteroffer" and then the very next day to agree upon
2 what was suggested and proposed by Welsh Water as fair
3 and reasonable.

4 I think we are entitled to say because they made
5 that offer it was the average that seemed fair and
6 reasonable, but a price higher than that which had not
7 been agreed between the parties would have been subject
8 to a review once again by the Tribunal. This I think
9 ended the Tribunal proceedings, very sensibly.

10 As part of the compromise, Albion suggested that the
11 figure of 14.4 should be updated by the PPI index for
12 the 2008 price. Welsh Water didn't respond to that
13 proposal, either to agree that that was the correct
14 method of indexation or to suggest an alternative, and
15 it's fair to say that Welsh Water didn't at any time
16 come forward with an up to date common carriage price,
17 because everything had been conducted in 2000 and 2001
18 prices.

19 There is that point, that Welsh Water almost came
20 away from the table and took a different tack, they
21 wanted Ofwat to determine an appropriate bulk supply
22 price, that is to say invoking section 40A. So their
23 attention was moved away from offering non-abusive
24 common carriage to look at the bulk supply arrangements,
25 and you will have seen in the evidence that Ofwat came

1 back with a bulk supply determination, which it's fair
2 to say is extremely unhelpful to Albion in, I think it
3 was October 2011, and it is that decision which is
4 subject to a judicial review. Indeed, Mr Pickford and
5 I have already locked horns in relation to that when
6 I had to make them work hard to get permission, which
7 I was successful in doing, to secure a judicial review
8 of the water resources element, the important element of
9 the determination itself.

10 So in those circumstances the suggestion that there
11 was any offer in relation to common carriage, that
12 Albion had refused to accept, or worse that Albion had
13 no genuine interest in common carriage so never would
14 have accepted a lawful common carriage charge price in
15 2001, in our submission simply cannot stand.

16 THE CHAIRMAN: Why are you not now operating on the basis of
17 the common carriage arrangement? Why are you still on
18 bulk supply from --

19 MR SHARPE: Still on bulk supply. Bulk supply, as a result
20 of Welsh Water persuading Ofwat to review it under
21 section 40A, became a live issue. It's a question which
22 in fairness ought to be directed to Dr Bryan in his
23 evidence, and no doubt will be, but I think the obvious
24 answer is that there is no satisfactory common carriage
25 price on the table.

1 THE CHAIRMAN: But there was after November 2008, you had
2 agreed 14.4 uplifted by some index or other, from then.

3 MR SHARPE: Some index or other; first of all, no index was
4 agreed. At that time, as the evidence shows, Albion was
5 waiting for Welsh Water to come back, they proposed PPI
6 and then they heard nothing. So it wasn't an offer
7 which it could regard as a definitive offer which they
8 could have gone back and then sought common carriage.

9 THE CHAIRMAN: But you accept that that breaks the chain of
10 causation, that the effect of the abuse finishes then
11 because your claim for compensation is up to
12 7 November 2008. It's not a trick question, Mr Sharpe,
13 I am just trying to ask you if there is
14 a straightforward answer to why you are still on this
15 apparently unfavourable bulk supply arrangement, rather
16 than having, one, your victory before the Tribunal and
17 got your offer of something above 14.4, why you didn't
18 move to that? It may be the cost of the water, I don't
19 know.

20 MR SHARPE: I think first of all this is a question for
21 Dr Bryan, and no doubt he will address it. I think the
22 answer he might give in passing -- and I don't want to
23 put words in his mouth -- is that there was not
24 a definite common carriage price at that time. I am
25 sure there are refinements to that.

1 Madam Chairman, I have about eight or nine pages to
2 go. I am happy to proceed, but I am also conscious of
3 others, and I know I will probably be no more than half
4 an hour or so tomorrow morning, if you wanted to adjourn
5 now. I wouldn't do this if it's going to inconvenience
6 my learned friend, but he is off to higher and better
7 things.

8 MR BEARD: Certainly not higher and better. If it would be
9 more convenient for the Tribunal to continue tomorrow
10 morning for another half an hour, there is no issue from
11 this side at all. There is the issue that I've put
12 a couple of markers down on.

13 THE CHAIRMAN: Yes.

14 MR BEARD: However, it may be, if that is the timing, that
15 those matters can be picked up in due course, perhaps
16 first thing on Wednesday morning, if that's necessary to
17 deal with those.

18 THE CHAIRMAN: Yes. How long is your opening going to be?

19 MR BEARD: I will defer to Mr Pickford on this, but we have
20 discussed it and he has said a day.

21 MR PICKFORD: I expect to have a fairly full day, Madam.

22 THE CHAIRMAN: Really?

23 MR PICKFORD: Yes.

24 MR SHARPE: Madam, I would be brisk tomorrow, and I think
25 I would be brisker with a bit of preparation.

1 THE CHAIRMAN: Yes, unfortunately I can't really sit earlier
2 than 10.30 tomorrow.

3 MR SHARPE: As long as we know, if my learned friend wanted
4 a bit longer.

5 THE CHAIRMAN: What else do you have to cover?

6 MR SHARPE: Compensatory damages, exemplary damages, and
7 then --

8 MR BEARD: I may have missed something, I thought that was
9 the case.

10 THE CHAIRMAN: There are things that you want to say on that
11 over and above what was in your skeleton?

12 MR SHARPE: I don't want to (inaudible) round the skeleton,
13 I would have sent you a video, Madam.

14 THE CHAIRMAN: If it's all right with the transcript
15 writers, we will carry on for a little bit now, and see
16 where we get to.

17 MR SHARPE: I want to turn briefly to some evidence of
18 compensatory damages. Welsh Water are doing no more
19 than any defendant does in damages proceedings, whether
20 they are competition cases or not. They are trying to
21 raise uncertainties in the hope of making it too
22 uncertain for the Tribunal to award damages. It's
23 always the case, it's a rare case where damages can be
24 quantified with precision. Sometimes, yes, but very,
25 very rarely, and it's particularly rare in competition

1 cases, where always you are dealing with hypotheticals.

2 So we are looking at a hypothetical world but we are
3 only looking at a hypothetical because Welsh Water
4 abused its dominant position, so Albion had no chance to
5 pursue common carriage or to pursue Corus as it would
6 have been able to do. So the uncertainty created was
7 entirely the result of Welsh Water's conduct which can
8 hardly be held against Albion. In terms of the specific
9 points made by Welsh Water, I have addressed a number of
10 them as they have arisen already in my review of the
11 background material, and many of the issues will turn on
12 the evidence, so cross-examination.

13 There are a small number of points I want to
14 address. First of all, they say Albion have not
15 suffered any loss because it would never have entered
16 into a bulk supply agreement with United. Now, the
17 contention presupposes that United would not have been
18 willing to offer any price below 9p per cubic metre.
19 Now, we will have to see the evidence on this, but it's
20 worth pointing out that United repeatedly told both
21 Welsh Water and Ofwat that it didn't consider it could
22 lawfully charge two customers different prices for the
23 same product, and therefore it had to charge Albion and
24 Welsh Water the same price. Now, obviously there are
25 ways of achieving that, and they exempted one

1 possibility after two attempts, that's the section 40
2 application. So that route, invoking Ofwat, was turned
3 down. Of course, Welsh Water showed not the slightest
4 intention, quite understandably, to increase the price
5 of its supply, so they weren't going to volunteer to
6 increase the price. So neither Ofwat nor Welsh Water
7 were going to oblige them with any increase in price.
8 By the same token, the bulk supply agreement, and they
9 were arguably in a dominant position, they didn't feel
10 they had any ability to say to Albion "go away" and
11 there is nothing in the evidence to suggest they didn't
12 feel a sense of obligation that they were obliged to
13 offer bulk supply. You will recall the terms of the
14 original Albion application.

15 So the only sensible assumption to make, the only
16 logical assumption is, if they couldn't increase the
17 price to Welsh Water either by agreement or by
18 compulsion, then given they had to supply Albion, they
19 would have had to charge Albion the same price, and they
20 really ought not to have too many crocodile tears over
21 that because as we know that price was the cost
22 perfector price, they knew what their costs were, they
23 were recovering them from Welsh Water, they had had them
24 scrutinised by Ofwat as well on two occasions and they
25 were plainly making money out of it, a reasonable

1 return, otherwise Ofwat would have reviewed it and
2 perhaps in their favour.

3 So there is no crocodile tears here. Nor, contrary
4 to their submissions to Ofwat, was there any shortage of
5 water by their own admission there was a surplus in the
6 area. We know that from some of the documentation, that
7 will come out in the evidence, perhaps more
8 appropriately and efficiently in the evidence, and
9 I give Ms White some early warning that that's one of
10 the questions I will be asking her.

11 But we also know from the evidence we have seen,
12 they weren't prepared to come in with Albion to try and
13 create an alternative source of supply: we have enough
14 water, we don't want to waste money on getting more
15 water than we need. That's essentially what they say.

16 So the question that Albion asked itself was simply
17 this: you had a cost-effective price, equality and
18 obligation of equity and non-discrimination, no
19 particular argument about different costs, it's the same
20 water going the same distance, and it is exactly the
21 same pretty well as the costs at Welsh Water we were
22 already incurring which were cost reflective and
23 registered in the Heronbridge Agreement, it was
24 a perfectly reasonable assumption to make that in the
25 end, after posturing, no doubt, United would have had to

1 supply at a non-discriminatory price, namely the price
2 they were charging Welsh Water. Of course, given what
3 we know about Welsh Water's position and obtaining their
4 rights under the agreement, they would have been quids
5 in, because they were going to get Welsh Water's revenue
6 and half of Albion's revenue, and after 18 months they
7 would get all of it, because of that transitional
8 provision, then the benefits were shared only for
9 18 months.

10 So on me reasonable view United would have been
11 foolish to have turned away Albion on this basis.

12 Now, all this is a matter of evidence, but those are
13 our submissions and those are the questions that no
14 doubt my learned friends will be putting to Dr Bryan.

15 THE CHAIRMAN: So you say that clause in the draft agreement
16 works to United Utilities' benefit even if not only the
17 price that Welsh Water pays remains at 3p but the price
18 that Albion pays remains at 3p, because Dwr Cymru still
19 has to pay that 3p for the 36 megalitres, that part of
20 that is being resold, or sold twice in a way, to Albion?

21 MR SHARPE: The straight answer is yes. What were
22 Welsh Water buying here? They were buying essentially
23 a right to the water, whether they took it or not.

24 THE CHAIRMAN: I see, and they say they wanted to keep that.

25 MR SHARPE: That's their case, they may not have realised

1 the implication of it, but it reduces the effective cost
2 to Albion of taking bulk water from United Utilities and
3 increases the effective revenue that United Utilities
4 would have received. In our respectful submission, the
5 evidence really points one way here, and it points in
6 favour of legality, namely equality, non-discrimination.

7 In relation to the common carriage price,
8 Welsh Water argues that it could lawfully have charged
9 a common carriage price of 16.5 pence per cubic metre
10 rather than the figure of 14.4p per cubic metre which
11 was agreed by the parties and ordered by the Tribunal at
12 the remedies hearing in 2009.

13 Now, in my respectful submission, this is not
14 an argument that is open to Welsh Water. I took you to
15 the reference to the origins of the 14.4p per cubic
16 metre. It was a figure proposed by Welsh Water, Albion
17 accepted in good faith as a compromise, despite the fact
18 there were real arguments available to suggest that the
19 correct figure was somewhat lower, and they took comfort
20 from that, from the Tribunal itself identifying a number
21 of additional points in its excessive pricing judgment
22 which indicated the correct figure was lower, for
23 example -- and I simply mention this -- for the cost of
24 capital, where the Tribunal concluded that the figure
25 used in the referred reference was excessive. But

1 Albion didn't consider it necessary -- sorry,
2 the Tribunal didn't consider it necessary to calculate
3 amended figures, because even if the correct cost of
4 capital had been adopted and reduced, the FAP would
5 still be unlawful on the basis of either set of figures.

6 So there were grounds for Albion to believe that the
7 figure it eventually compromised was actually a fairly
8 generous one as far as Welsh Water was concerned.

9 Now, if Welsh Water had wanted to argue for a higher
10 non-abusive price, then the remedies hearing was the
11 time to do so. But having proposed 14.4 per cent as
12 a compromise figure, and Albion having accepted it, it
13 is simply no longer open to Welsh Water to argue for
14 a higher price as the basis of any calculation quantum
15 or, in this case, to see whether or not Dr Bryan would
16 have accepted it.

17 Welsh Water also suggests that Albion would never
18 have accepted a lawful common carriage price. Well, the
19 primary basis for this assertion is that Albion was
20 contending that a proper common carriage price was 7p
21 per cubic metre, so Albion would not have accepted
22 a common carriage price that was in the end twice that
23 figure. Again in our respectful submission that is
24 another commercially absurd argument, for the same
25 reason. If a commercially viable common carriage price

1 had been offered, it would have been wholly irrational
2 for Albion not to immediately take the opportunity to
3 lower its costs, even if it considered it had grounds to
4 challenge the price, because Albion could take the
5 benefit of that saving immediately and then pursue with
6 Ofwat any complaint it felt it had subsequently, then it
7 could do so.

8 There is enough evidence in the bundle to show that
9 both Welsh Water and United were all too conscious of
10 Albion's ability to complain to Ofwat whether it's about
11 competition matters or whatever.

12 To repeat a point I made this morning briefly, we
13 saw Albion's reaction to this dramatic reduction from
14 27.4 down to 26 after the "minded to" decision. They
15 could have walked away and said give it up, because
16 there is no margin. But they took a rather gutsy
17 decision because they wanted to get into the market and
18 then see what would happen. There is no reason to think
19 that the same company a few years later would take
20 a different view in relation to a commercially sensible
21 common access price.

22 The final point I would like to address is the
23 suggestion that Albion would have had to spend
24 £3 million in order for United Utilities to increase its
25 pumping capacity at Heronbridge. Now, the premise of

1 this is, I think, by now perhaps a little bit absurd.
2 You will have seen it. It rests upon Welsh Water
3 continuing to demand not merely the right but exercising
4 the right over the water so the total water that came
5 through the system would exceed the capacity of the
6 system. Or if it went from 36 to 50, then extra work,
7 extra pumping stations and everything else, would have
8 to be introduced.

9 The most obvious point on this is, first of all,
10 there is a difference between entitlement and demand, we
11 have seen that, but even if they had maintained the
12 contractual right to 36 megalitres a day, it's no
13 evidence at all before this Tribunal as to what they
14 would have done with it. It can only go to two
15 customers and if Shotton water was contracted with
16 Albion, what would they have done with it? Would they
17 just simply have leaked it out? Flooded Heronbridge and
18 Ashgrove? I ask that not wholly frivolously because if
19 they were demanding the right to have the water
20 delivered, there was quite simply nobody there to take
21 it, and everybody knew this, and even United Utilities
22 started off with the initial assumption, I think
23 I showed you a piece of paper in the documents, that
24 this would be in place of Welsh Water. Now they say:
25 ah, well, it isn't actually. The reason for that is

1 they want to load up the extra costs of the expanded
2 capacity on Albion to justify an even higher charge.

3 Of course I could rehearse the point as well that at
4 no time has Welsh Water taken anything like its
5 entitlement. We are talking 20, 22, 26 megalitres out
6 of 36. There was always a healthy surplus, and indeed
7 the evidence shows that that surplus was growing over
8 time, not reducing.

9 I wanted to address those principal points, none of
10 them particularly important, but they have some traction
11 in the minds of my learned friends and I thought it
12 might be useful just to deal, and I hope dispose of them
13 quickly now and perhaps we won't hear any more of them
14 again.

15 I want to say, in conclusion, and I'll be brief,
16 a few words on exemplary damages. In the light of the
17 Tribunal's decision in 2 Travel v Cardiff City Transport
18 there is, I hope, no longer any doubt that the Tribunal
19 has the power to award exemplary damages in appropriate
20 cases where no penalty has been imposed. As
21 the Tribunal made clear in that case, exemplary damages
22 should be awarded where a party has acted in breach of
23 the competition laws, either knowing that what they were
24 doing constitutes an infringement or was reckless as to
25 what they were doing constituted an infringement.

1 You will recall what would be classified as reckless
2 the Tribunal prayed in aid Lord Bingham's definition in
3 R v G 2004, essentially a knowing disregard of an
4 appreciated and unacceptable risk of causing
5 an injurious result or a deliberate closing of the mind
6 to such a risk.

7 Respectfully we rely on that formulation as being,
8 with the greatest respect to Lord Bingham, absolutely
9 sound and easy to adapt to this context.

10 The issue for the Tribunal can therefore be
11 summarised as whether Welsh Water knew that the FAP was
12 excessive or was reckless about whether it was excessive
13 and therefore abusive.

14 Welsh Water's answer to that is to point to the
15 number of years it took for Ofwat and the Tribunal to
16 consider the FAP, and the work involved in determining
17 what the proper price and suggest on that basis that it
18 can't possibly be said that Welsh Water knew or were
19 reckless about the FAP being excessive.

20 In my respectful submission, that argument
21 completely misses the point. The only relevant question
22 for exemplary damages is whether Welsh Water knew it was
23 overcharging or was reckless about whether it was. As
24 long as Welsh Water knew a proper cost based price would
25 have been materially lower than 23.2p, and there is

1 enough evidence to prove that, or was reckless about
2 what a proper cost based price would be. It doesn't
3 matter whether Welsh Water knew exactly what the correct
4 price would be or would have come to exactly the same
5 figure that the Tribunal did. It is sufficient that it
6 knew that it was overcharging, abusively so, and didn't
7 care, particularly in circumstances where it knew full
8 well that it meant that the common carriage was a dead
9 letter and could therefore profit by that result.

10 Looking at the totality of the evidence, Albion will
11 suggest that the answer is clear: Welsh Water were
12 seeking one thing, the price that would maintain their
13 existing profits, revenue neutrality in the language of
14 the board minute, and Welsh Water was prepared to go
15 through whatever accounting gymnastics to prove this,
16 and I put "prove" in quotation marks.

17 It was perfectly clear, well advised as they were,
18 that Welsh Water was well aware of their
19 responsibilities under the Competition Act, and yet
20 there is nothing in the documents to show that
21 Welsh Water gave any real thought, let alone took legal
22 advice, as to how they could lawfully charge the price
23 which substantially exceeded their actual costs, and
24 they knew that, from 1996 onwards.

25 Now, there are lots of good reasons why lawyers are

1 not consulted, apart from expense, and that's hardly
2 been a consideration for Welsh Water. The main reason
3 is when a client knows the law and believes there is no
4 need to seek advice. It's all very clear. But was this
5 a situation in which the law was manifestly clear? Or
6 is this one of those situations where Welsh Water had
7 a pretty good idea for what the advice would have been,
8 that their conduct was illegal or teetering on the edge
9 of illegality? So they thought it best not to enquire
10 further.

11 There is a lot of money at stake. So they neglected
12 this analysis as indicative of just the cynical
13 disregard of the law which exemplary damages was
14 designed to capture. The evidence suggests that they
15 either must have been aware that their conduct was
16 clearly or probably unlawful, or simply didn't care.

17 In our submission, that is exactly the position, and
18 the reason why Welsh Water was so secretive about its
19 methodology, and the accounting information. It may
20 also explain what I am obliged to say, what appears to
21 be the covering of tracks up to and including the fact
22 that there was no board meeting or no minute of a board
23 meeting in February 2001 when the FAP was apparently
24 approved.

25 In relation to treatment costs, which I mention

1 frequently, Welsh Water chose to use the figure of
2 30 per cent potable treatment without carrying on any
3 real analysis to test whether that was correct or not,
4 and in full knowledge it wasn't robust. Yet we now know
5 that when some analysis was done, the relevant
6 percentage was halved, we have seen that.

7 In relation to distribution costs, they took the
8 costs for an entirely different service, the bulk
9 potable costs of distribution, which everybody in
10 industry knows are multiples of the costs of
11 distribution for non-potable water, much more expensive.
12 When Albion sought to question the figures and the
13 methodology such as in the meeting in November 2000,
14 Welsh Water exaggerated the costs by claiming there were
15 substantial costs in relation to sludge, when in fact --
16 as will come out in evidence -- there were no material
17 costs involved in this at all.

18 Then when Ofwat becomes involved, Welsh Water
19 concealed actual information on their costs, the local
20 asset register and the local accounting information,
21 it's the information which was not supplied in response
22 to the section 26 response and should have been, and
23 instead put forward D21. We aren't trying to run away
24 from D21, but they put it forward perfectly
25 satisfactorily to meet Ofwat's requests and now they

1 tell us actually it wasn't quite as accurate as it
2 should have been. It doesn't matter.

3 They put that in, which contained calculations which
4 anybody could have seen were hopelessly inflated, and
5 you will see Dr Bryan's evidence, and I drew your
6 attention to the management on-costs. Arguably they
7 knew the real facts because they would have known what
8 their on-costs were, and when they did subject it to
9 analysis and were prepared to share it, the on-costs get
10 down to a penny instead of 6.2, and they only came close
11 to the figure they required by including that management
12 on-cost because it served its purpose of inflating the
13 cost to the point where Albion could not conceivably go
14 forward on that basis.

15 So it all makes sense in pursuit of Welsh Water's
16 revenue neutrality, and the result of that is that of
17 course Albion could not enter the market in the most
18 profitable way, common carriage, couldn't develop
19 a viable business, they were prepared to be reckless at
20 best in the discharge of their duties and obligations
21 under the competition law to achieve that goal.

22 All this and more will emerge in the course of
23 cross-examination. Unless I can assist you further,
24 those are our opening submissions.

25 THE CHAIRMAN: Thank you very much, Mr Sharpe. Thank you

1 very much, I think it was useful to finish that today.

2 MR SHARPE: Yes.

3 Housekeeping

4 THE CHAIRMAN: Yes. Now, Mr Beard?

5 MR BEARD: In relation to the unpleaded issues point,
6 unfortunately in the light of the brief summary that
7 Mr Sharpe has just given, I think there will have to be
8 added two other points: the absence of a request for
9 legal advice which has never been raised previously and
10 the failure to comply with section 26 notice which again
11 has never been part of the case.

12 I suggest given the time that it is not sensible to
13 be dealing with these matters now and perhaps it is
14 sensible to postpone them until Wednesday morning.

15 THE CHAIRMAN: What I suggest, really they relate to what
16 questions can be asked of your witnesses, and they need
17 to be resolved before then. I must say I would hesitate
18 at this stage to allow questions about whether legal
19 advice was taken, whether in-house or external advice,
20 I'm not sure that's a useful road to go down at this
21 stage, when it's certainly not been explored so far as
22 I can see so far, and similarly in relation to the
23 section 26 notice it doesn't seem to me that we know
24 what information was provided, nor is it going to be
25 easy to find that out.

1 MR BEARD: Well, it's more than that, no accusation has been
2 made in relation to it.

3 THE CHAIRMAN: Yes. But as far as the point that you have
4 been alerting us to during the course of today, that is
5 a point that we will have to get to the bottom of.

6 MR BEARD: Yes.

7 THE CHAIRMAN: And it seems to me that it needs to be
8 resolved at some point between now and the time your
9 witnesses go into the witness box, because I am not sure
10 that you would have any questions to ask Dr Bryan about
11 those matters.

12 MR BEARD: Well, there may be in relation to Dr Bryan has
13 put forward evidence in relation to, for instance, he
14 has suggested that what was going on was misleading by
15 Dwr Cymru in the pre-1999 phase. Now, there is one
16 approach to that, which is to say: well, it's not for
17 him to give evidence in relation to those matters, in
18 which case there is no need to cross-examine. Similarly
19 for him to be saying Mr Holton is misleading, in
20 circumstances where these matters aren't pleaded and
21 there has been various references to Mr Holton not being
22 called as a witness, we have called the witnesses who we
23 thought were most relevant, the person who was involved
24 in the numbers and the person who is the board member.
25 If the concern is Mr Holton should be made available,

1 then I am sure that can be done. But of course these
2 weren't matters that were trailed at the time when the
3 witnesses were identified.

4 THE CHAIRMAN: I do not see that there is any point in you
5 cross-examining Dr Bryan about inferences that he draws
6 from the documents about which he can't give direct
7 evidence and which are a matter of submission, and it
8 seems to me at the moment that those would include the
9 first point that you made about the pre-1999 phase.

10 MR BEARD: Yes. The only other issue is obviously the
11 allegation of covering tracks that is being made now,
12 that isn't trailed in any pleading.

13 THE CHAIRMAN: Well, that is something that I assume that
14 Mr Sharpe would want to ask the witnesses about, so we
15 do need to resolve whether that's -- but I don't want to
16 prolong this evening's proceedings, I would like you to
17 discuss between yourselves when would be an appropriate
18 moment between now and the time that the first Dwr Cymru
19 witnesses come for us to tackle that issue.

20 MR BEARD: I am grateful, thank you very much.

21 MR SHARPE: Well, Madam, I appreciate that, no doubt we will
22 have to make time on Friday, I guess, because my friend
23 says he will need Dr Bryan for up to two days. Can
24 I lay down a marker? I think I am perfectly entitled to
25 ask about legal advice, that is not in contention in

1 2 Travel, and if it goes to --

2 THE CHAIRMAN: Well, 2 Travel was a very particular set of
3 circumstances in which it became relevant what the legal
4 advice had been and in which there was a waiver of legal
5 privilege for particular reasons. Now, I don't see
6 Mr Beard waiving privilege any time soon, and in those
7 circumstances I don't see the point of asking questions
8 which one cannot then either prove or disprove the
9 truthfulness of the answer without getting into
10 privileged matters, and I think it's awkward for the
11 witnesses to no real purpose.

12 MR SHARPE: Mr Beard may be going a bit further than that.
13 He is saying that I'm not willing to make submissions
14 about the absence of any evidence, that they had
15 satisfied themselves as to legality.

16 THE CHAIRMAN: The absence of documents like board minutes,
17 that's a completely different thing, but to say, as you
18 did, "Well, the only reason why they could not have
19 asked for legal advice was because they knew they would
20 get the wrong answer", that is a completely different
21 matter and I am very far from being persuaded at the
22 moment that that would be a useful course for anybody to
23 start pursuing in these proceedings. I will leave it at
24 that for the moment, Mr Sharpe.

25 There is one matter that I would like to raise

1 before we finish, which is what the outcome of this
2 hearing is going to be. In one of the paragraphs of
3 your skeleton, Mr Beard, you suggested that the Tribunal
4 could decide all the issues raised as regards what the
5 counterfactual world is in terms of the price of water
6 from United Utilities, in terms of indexation, in terms
7 of expenditure on extra pumping and connection costs,
8 dozens of different variables, and then we would deliver
9 judgment on that and the parties would crunch the
10 numbers and come up with what that means in terms of
11 money owed or not. That is unsatisfactory in the sense
12 that it seems from the authorities that when considering
13 the quantum of any exemplary damages to be awarded, the
14 quantum of the compensatory damages is a relevant factor
15 in that.

16 So we would like to be in a position, at the end of
17 the hearing, when we deliberate, to have some model in
18 which we can input the figures and come up with our own
19 computation of what the consequences of our findings
20 are. Clearly at that stage it's going to be difficult
21 to ask the parties to do those computations without
22 giving you hints as to where our thoughts are turning.
23 That is what we would like to be in a position to do.
24 It probably involves an Excel spreadsheet of some degree
25 of complication which I hope can be explained to us, of

1 the various parameters that we can then say "Well,
2 suppose we then find that the United Utilities price was
3 this, we think that it's more likely it would have been
4 this indexation or that, we think the contract would
5 have started on 1 March or 1 October or some other
6 time", you understand what I am saying, so that we can
7 do the number crunching in however amateur a manner, so
8 that we can have an idea of what our decision means in
9 terms of the level of compensatory damages, so that if
10 we then decide that this is a suitable case for
11 exemplary damages we can bear that in mind when
12 considering the quantum of exemplary damages.

13 This is not an urgent task because we really, as
14 I say, only need this when we come to deliberate, but
15 I thought I would flag it up at this stage so the
16 boffins on either team can work out how best to deal
17 with this.

18 MR BEARD: I am grateful for the indication. It was partly
19 the complication of trying to draw those sorts of
20 conclusions that pointed us in the direction that we
21 went in, in the skeleton argument. I think the best
22 thing to do is to take that away and discuss with those
23 behind me, because I am not going to pretend any great
24 expertise in Excel and see where we can get to and
25 perhaps revert later in the week or at the beginning of

1 next week, which will provide adequate time that these
2 arrangements can be made.

3 MR SHARPE: And to some extent we have already done the
4 exercise in the appendix to our pleadings, but I am
5 instructed that we can handle what you are seeking.

6 THE CHAIRMAN: Yes, I don't think your model necessarily
7 incorporates all the variables that they suggest, and
8 their model doesn't incorporate all the variables that
9 you suggest, but we are going to have to make decisions
10 on all of those and so they need to be defined in some
11 way.

12 MR SHARPE: We have to achieve the impossible and reach
13 a measure of agreement.

14 MR BEARD: I am sure we will manage it, yes.

15 MR SHARPE: I am sure we can as well.

16 THE CHAIRMAN: I have every confidence in you. Well, we
17 will start, then, at 10.30 tomorrow morning. Thank you
18 very much.

19 (5.00 pm)

20 (The court adjourned until 10.30 am
21 on Tuesday, 16 October 2012)

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23

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INDEX

PAGE

Opening submissions by MR SHARPE2

Housekeeping166

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25