**IN THE COMPETITION APPEAL TRIBUNAL**

Case No: 1046/2/4/04

Victoria House
Bloomsbury Place
London WC1A 2EB

6 October 2006

Before:

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

Sitting as a Tribunal in England and Wales

BETWEEN:

**ALBION WATER LIMITED**

Appellant

supported by

**AQUAVITAE (UK) LIMITED**

Intervener

-v-

**WATER SERVICES REGULATION AUTHORITY**
**(formerly DIRECTOR GENERAL OF WATER SERVICES)**

Respondent

supported by

**(1) DŴR CYMRU CYFYNGEDIG**

and

**(2) UNITED UTILITIES WATER PLC**

Interveners

# SUMMARY OF JUDGMENT AND CONCLUSIONS

**(Reproducing Sections I and XVI of the Tribunal's judgment of 6 October 2006)**

## APPEARANCES

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

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

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

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

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

## I SUMMARY: THIS CASE IN A NUTSHELL

1. Albion Water Limited ("Albion") appeals to the Tribunal against the Decision dated 26 May 2004 ("the Decision") of the Director General of Water Services ("the Director"), now the Water Services Regulatory Authority ("the Authority")[1] adopted under the Competition Act 1998 ("The 1998 Act"). The Decision is to the effect that the price of 23.2p/m³ ("the First Access Price"[2]) offered by Dŵr Cymru to Albion on 2 March 2001 for the "common carriage" of non-potable water[3] across what is known as the Ashgrove system, did not constitute an abuse of a dominant position contrary to the Chapter II prohibition imposed by section 18 of the 1998 Act.

2. This case raises some important issues regarding the application of the Chapter II prohibition in the water industry in England and Wales, which is characterised by vertically integrated companies with *de facto* monopolies within their designated areas. A further aspect is the interaction between the 1998 Act and the regulatory system established by the Water Industry Act 1991 ("the WIA91"), as notably amended by the Water Act 2003 ("the WA03"). The 1998 Act applies notwithstanding the provisions of the WIA91: see sections 2(6A), (6B) and (7), section 31 and section 66D(9) and (10).

3. The following is a broad, non-technical summary of this case and the Tribunal's principal findings, the detailed reasons for which are set out in this judgment.

*The Background*

4. Shotton Paper, situated on Deeside, is part of UPM, an international Finnish Group, and has one of the largest paper-making plants in Europe. Shotton Paper consumes

[1] The Authority replaced the Director pursuant to the provisions of the Water Act 2003 on 1 April 2006. In this judgment we have, for convenience, continued to refer to the Director although as regards the period after 1 April 2006 we refer, where appropriate, to the Authority. In this judgment the expression "the Director" includes the Authority.

[2] A slightly different Access Price was indicated by Dŵr Cymru to the Director in 2004. This price is referred to as "the Second Access Price" but is not dealt with in the Decision; (paragraph 249).

[3] Non-potable water is, essentially, water that is of insufficient purity to be used as drinking (i.e. potable) water. Non-potable water may be partially treated or "raw" (i.e. untreated) water. In the notice of appeal Albion uses the expression "non-potable" to cover all water that is not potable, whether raw or untreated (paragraph 86).

large quantities of non-potable water in its production processes – equivalent in volume to the annual consumption of about 35,000 to 40,000 domestic customers – and is the second largest user of water in Wales.

5. Shotton Paper is supplied with non-potable water via the Ashgrove system, which is owned by Dŵr Cymru. The water is extracted from the River Dee at Heronbridge and supplied to Dŵr Cymru by a neighbouring water undertaker, United Utilities. The Ashgrove system consists of a treatment works near Heronbridge, where the water is partially treated, and a single 700mm pipeline through which the water descends by gravity over a distance variously estimated at between 15 and 16.5 kilometres to the Shotton Paper site and that of a neighbouring steel producer, Corus.

6. Until 1999, Shotton Paper was supplied by Dŵr Cymru at a retail price of 27.47p/m³. The difference between Dŵr Cymru's buying price for the water from United Utilities and its retail price to Shotton Paper appears to have given Dŵr Cymru a gross margin of around 87 per cent of the retail price paid by Shotton Paper.

7. In 1999 Albion – the only water undertaker to enter the industry since privatisation in 1989 – obtained an inset appointment to operate as a statutory water undertaker in respect of the premises of Shotton Paper, and Shotton Paper transferred its custom from Dŵr Cymru to Albion. Under the various supply arrangements between the parties, Dŵr Cymru sells the water in question to Albion at the premises of Shotton Paper under an agreement known as the Second Bulk Supply Agreement at a price of 26p/m³. Albion resells the water to Shotton Paper under its supply agreement with the latter at the same price of 26p/m³. The cost to Shotton Paper of water at a retail price of 26p/m³ is approximately £1.7 million per annum.

8. In 2000, Albion requested Dŵr Cymru to quote a common carriage price for the partial treatment and transportation of water through the Ashgrove system. Albion's proposal was, and still is, that Albion would buy the water directly from United Utilities at Heronbridge, and resell the water to Shotton Paper, paying Dŵr Cymru a reasonable price for the use of the Ashgrove system. In February 2001, Dŵr Cymru quoted Albion a common carriage price, known in these proceedings as the First Access Price, of 23.2p/m³.

9. Albion complained to the Director on 8 March 2001 that the First Access Price was (i) excessive and (ii) gave rise to a "margin squeeze", contrary to the Chapter II prohibition imposed by the 1998 Act. The alleged margin squeeze arose because Albion could not acquire the water from United Utilities (at a cost of over 3p/m³), pay the First Access Price of 23.2p/m³, and resell the water to Shotton Paper, except at a price above Dŵr Cymru's retail price of 26p/m³ then available to Shotton Paper.

*The Decision*

10. In the Decision adopted on 26 May 2004 the Director rejected Albion's complaint. As to the allegation of excessive pricing, the Director found that on an average accounting cost basis a common carriage price of 19.2p/m³ would have been justified, comprising 3.2p/m³ for treatment costs and 16p/m³ for "distribution" costs. The Director further applied an approach known as the Efficient Component Pricing Rule ("ECPR"), which essentially involves taking the prevailing retail price and deducting the cost which the incumbent avoids by not making the supply in question (here, according to the Director, the water resource cost which Dŵr Cymru would no longer incur). Applying that ECPR approach, the Director found that an access price of 22.5p/m³ would have been justified. According to the Director, a similar result would be arrived at by the application of the Costs Principle set out in section 66E of the WIA91 which, although not in force at the time, now applies when calculating charges to certain new suppliers licensed under that Act. As to the allegation of margin squeeze, the Director rejected Albion's complaint essentially on the basis that, in supplying Albion by way of common carriage, Dŵr Cymru would not be saving any costs.

11. The effect of the Decision is to render uneconomic Albion's proposal to supply Shotton Paper via common carriage, and largely to remove the viability of Albion's existing inset appointment. The consequent removal of choice for the customer, Shotton Paper, and the potential elimination of the only new undertaker to enter the water industry since 1989, are matters which the Tribunal views with serious concern, particularly against the background of recent policy to encourage competition in the water industry as regards supplies to large industrial users, as set out in MD Guidance Letters issued by the Director, in a Consultation Paper published by the Government in 2002, and in the WA03 enacted by Parliament.

*The Tribunal's findings*

12. Dŵr Cymru has some 1.3 million customers, most of whom are 'tariff' customers, but only about a dozen large customers using non-potable water for industrial purposes. Non-potable water appears to have accounted at the material time for about 3 to 4 per cent of Dŵr Cymru's water services revenue. In England and Wales as a whole non-potable supplies appear to account for less than 0.5 per cent of water services revenue.

*- The average accounting cost issues*

13. As regards the average accounting cost approach used in the Decision to determine the First Access Price, there is evidence that the cost of treating non-potable water was over-estimated in the Decision. However, the Tribunal is prepared to assume, without deciding, that treatment costs are in the range 1.6p/m³ to 3.2p/m³.

14. The principal issue on this aspect of the case is the justification for the "distribution" cost element of the First Access Price, found by the Director to be 16p/m³. This represents a revenue to Dŵr Cymru of over £1 million per annum. According to the Decision, operating costs represent some 1p/m³. However, no accounting information or other documentation was produced to the Tribunal to show what costs the remaining 15p/m³ – representing some 94 per cent of alleged distribution costs – was intended to cover.

15. The figure of 16p/m³ for distribution costs used in the Decision has remained almost wholly unparticularised throughout the proceedings, and it has proved impossible for the Tribunal to identify, let alone verify, the constituent elements of that figure. In the Decision there was little, if any, attempt to disaggregate costs relating to specific activities such as retail activities.

16. The Tribunal has encountered a number of difficulties with the underlying data provided by Dŵr Cymru, such that the Tribunal's general approach has been to be cautious about relying on any such data.

17. The principal justification advanced in the Decision for the figure of 16p/m³ for "distribution" costs is the contention that it can be safely assumed that the cost of

distribution for non-potable water is the same as the cost of the distribution of potable water (paragraph 302). The Tribunal has examined that contention from four different aspects, namely the characteristics of potable and non-potable systems respectively; Dŵr Cymru's justification for its Large Industrial Tariff (LIT) for potable users introduced in 1999; the cost of transporting raw water; and the costs attributable to the Ashgrove system. None of those approaches come anywhere near justifying the figure of 16p/m³ for "distribution" costs used in the Decision, let alone the First Access Price of 23.2p/m³.

18. As to the comparison between potable and non-potable systems respectively, the Tribunal is not satisfied that the differences between the large conjunctive use potable systems in South Wales serving up to 500,000 customers on the one hand, and the self-standing, discrete, non-potable systems serving one or perhaps two individual customers, on the other hand, were fully taken into account in the Decision. In particular, the predominantly rural location of non-potable systems; differences in the need for service reservoirs and distribution pumping (and the associated depreciation charges) on non-potable as distinct from potable systems; and the evidence as to greater expenditure as regards investment, infrastructure renewals, maintenance and leakage on potable systems as compared with non-potable systems, mainly as a result of regulatory requirements affecting the former but not the latter, were not taken sufficiently into account in the Decision.

19. In particular the Tribunal is not persuaded by Dŵr Cymru's attempt to equate "pumping at source" on non-potable systems with the "distribution pumping" commonly found on potable systems, nor by its attempt to equate the relatively few tanks and storage facilities found on some non-potable systems with the service reservoirs found extensively on potable systems. Dŵr Cymru was unable or unwilling to provide any figures to rebut the evidence before the Tribunal that there has been little or no investment, maintenance, leakage or waste detection expenditure on non-potable systems, whereas there has been considerable expenditure on potable systems in these respects. The Tribunal was told that the Ashgrove pipeline was merely "walked twice a year", although it appears to leak about 1 million cubic litres (220,000 gallons) annually. These matters, in the Tribunal's view, were not sufficiently investigated in the Decision.

20. Dŵr Cymru's justification for the LIT contained in a letter to the Director of 2 December 1998 – the only document containing even rudimentary information on actual costs with which the Tribunal was provided – raised in the Tribunal's mind further questions as to the comparability, from the costs point of view, of potable and non-potable systems.

21. The evidence before the Tribunal as to the average transportation cost for "raw" (i.e. untreated) water (in the range of 2p/m³ to 4p/m³), compared to the alleged average "distribution" cost for "non-potable" water of 16p/m³, further supported Albion's contention that the "distribution" cost of 16p/m³ was significantly over-stated. Most of the "non-potable" systems here in question in fact transport raw water, and there is no material physical difference between the transportation of raw water, and the transportation of "non-potable" water, whether raw or partially treated.

22. In relation to the Tribunal's wish to understand the costs specifically attributable to the Ashgrove system, Dŵr Cymru was unable or unwilling to provide any historical information on such costs, and withdrew certain cost information supplied to the Director during the administrative procedure on the basis that such information "did not offer incremental insight". These were major weaknesses in Dŵr Cymru's intervention.

23. Instead, both Dŵr Cymru and the Authority sought to justify the First Access Price on the basis of what it would cost a new entrant to build the Ashgrove system from scratch on a greenfield basis. The resulting allegedly "stand alone" calculations showed that an access price in the region of the First Access Price could be justified only by assuming a rate of return on the assumed capital values in question of some 15 times Dŵr Cymru's normal rate of return on capital. That, in itself, was strong evidence that the First Access Price was not cost based and/or was excessive.

24. It was accepted in evidence that these "stand-alone" cost calculations produced by Dŵr Cymru and the Authority – which were the only cost calculations they produced – could not be used as a basis for charging.

25. In the result, the Tribunal was left with a large gap between Albion's evidence to the effect that distribution costs for the transportation of non-potable water, properly calculated, amount to around 2p/m³, on the one hand, and the figure of 16p/m³ for "distribution" costs relied on in the Decision, and the First Access Price of 23.2p/m³ on the other hand. Although given the opportunity, neither Dŵr Cymru nor the Authority gave any clear or convincing explanation as to how that gap could be bridged, or how the "missing" costs could be accounted for.

26. The Authority placed weight on a "regional average" approach to pricing which, said the Authority, precluded any examination of the costs specifically attributable to Ashgrove. However, the evidence in this case is that "regional averaging" in relation to the large non-potable customers of Dŵr Cymru was, at the material time, virtually non-existent. All the customers in question were on special agreements. A tariff for large non-potable customers, known as the New Tariff, was introduced only in 2003, some two years after the First Access Price was quoted. Few customers have migrated to that tariff. Corus, one of Dŵr Cymru's major customers, has resisted being charged in accordance with that tariff, and High Court litigation is in progress.

27. The Authority's submission that, even with special agreements, "location-related" charging was not permissible, was seriously weakened by the existence of an exception in the Authority's document RD 09/03 which applies "when infrastructure is exclusive to the customer(s) being charged". That is the case here. The Authority did not draw the Tribunal's attention to this exception in the course of argument.

28. In those circumstances the Tribunal did not consider that the practice of "regional average pricing" precluded an examination of the costs specifically attributable to Ashgrove as a cross-check on the First Access Price. In the Tribunal's view the attempted application of "regional average pricing" across the discrete, physically different and geographically separate non-potable systems in Wales, without examining the underlying costs in more detail, runs the risk of causing market distortions and/or discrimination.

29. In all those circumstances, in the Tribunal's judgment the matter of the "distribution" cost of non-potable water on an average accounting cost basis was not sufficiently

investigated. On this aspect the Decision is incorrect, or at least insufficient, from the point of view of the reasons given, the facts and analysis relied on, and the investigation undertaken, as regards in particular the conclusion set out in paragraph 302.

30. Furthermore, even doubling Albion's figures, to take account of elements possibly understated or omitted, would produce a common carriage price of less than half the First Access Price. In the Tribunal's view, the evidence taken as a whole strongly suggests that the First Access Price was excessive in relation to the economic value of the services to be supplied, by reason of the absence of any convincing justification for the "distribution" costs included in the average accounting cost calculation.

*- The ECPR issues*

31. As to the ECPR approach to access pricing also used in the Decision to support the First Access Price, the evidence before the Tribunal is that ECPR is a controversial methodology which has been criticised in other contexts for having adverse effects on competition, and has been expressly banned under New Zealand telecommunications legislation.

32. It was accepted in evidence by the Authority that the ECPR approach in the Decision insulated the incumbent in perpetuity from competition, required the new entrant to indemnify the incumbent indefinitely for any loss of revenues (except for "avoidable costs"), effectively required the new entrant to support the incumbent's overheads as well as its own, and required the new entrant to be "super-efficient" as compared with the incumbent. While, in view of the Tribunal's other findings, it is unnecessary to decide whether ECPR is in all circumstances *intrinsically* contrary to the Chapter II prohibition, such an approach to pricing at the very least requires close scrutiny under that prohibition.

33. In the Tribunal's view the particular ECPR approach used in the Decision cannot be safely relied on in this case since (i) the "retail" price used in the calculation is not shown to have been reasonably related to costs; and (ii) the evidence strongly suggests that that price was excessive.

34. In addition, the particular method of application of ECPR in this case will in the Tribunal's view eliminate competition, and prevent virtually any entry into the market, because the margins produced by the ECPR approach used in the Decision tend to be non-existent or too small to make entry viable. For that reason too the ECPR approach used in the Decision cannot be safely relied on in this case.

35. The evidence of the Authority's expert Professor Armstrong and the submissions of the Authority and Dŵr Cymru before the Tribunal on the issue of "avoidable costs" appeared to adopt a different approach to that adopted in the Decision. The Decision is based on the cost allegedly avoided in the short run by serving one less customer, an approach described by Professor Armstrong as giving rise to a "horrible practical aspect" and not supported by him without qualification. The evidence and submissions of the Authority and Dŵr Cymru variously suggested that it would be appropriate to take a medium to longer term time frame; that all retail costs were avoidable and would fall to be deducted from the access price; and that, in Professor Armstrong's view at least, it would be appropriate to make some forecast of the likely scale of entry and deduct avoidable costs on an averaged basis of some kind. Those various considerations do not figure in, or appear to be consistent with, the Decision. For that further reason, it is unsafe to rely on the ECPR approach adopted in the Decision.

36. The principal general arguments relied on by the Authority to justify its ECPR approach were that (i) ECPR enables incumbents to continue to recover their sunk and common costs, and to fund their investment requirements; (ii) ECPR protects customers ineligible to benefit from competition from increased costs, particularly the costs of stranded assets; and (iii) ECPR maintains the cross-subsidies implicit in regional average pricing.

37. Irrespective of the justification in principle for a policy designed to enable incumbents to recover their sunk and common costs and fund investment, which may well be reasonable in itself, the particular application of ECPR in this specific case eliminates existing competition and any reasonable prospect of new market entry, and maintains a retail price which is not shown to be cost-based and which the evidence strongly suggests to be excessive.

38. The argument as to stranded assets was central to the Authority's submissions, but in the Tribunal's view had no application in the present case, since there was no asset that would be stranded if Albion's common carriage proposal took effect. The Authority's expert evidence was that ECPR is not appropriate if there is a potential risk of bypass. To the extent that the Director suggested in the Decision that bypassing the Ashgrove pipeline could be feasible, on the Authority's own expert evidence an ECPR-type calculation was not appropriate in the Decision.

39. As to "regional average pricing", the Authority's case was not based on any need to maintain cross-subsidies between household and industrial customers, because such cross-subsidies had been largely unwound, but on the proposition that large industrial customers in the non-tariff sector open to competition should be required *to cross-subsidise each other.* The Tribunal saw no basis in fact or law for applying this unusual argument to large non-potable customers in Wales, for the reasons already given at paragraphs 26 to 28 above.

40. While in many cases regional averaging in the potable sector may be appropriate on practical or other grounds, this case is not dealing with that sector. However, where there are identifiable and significantly different costs of supply between large customers, a failure to reflect those differences in the prices charged could in the Tribunal's view give rise to difficulties under both the Chapter II prohibition and Condition E of undertakers' appointments.

41. The Authority's suggestion that a move away from regional average pricing would cause major difficulties for some large customers was not supported by any evidence and did not appear relevant to the facts of the present case. The Authority's suggestion that water undertakers would act in the future so as to drive major customers out of business was an implausible and probably unlawful scenario.

42. We were told in evidence that the Authority was not concerned with whether industrial companies for whom water was a major input remained internationally competitive or not. The Authority did not consider that whether plants or developments were sited efficiently, for example from the point of view of the use of water resources, was a

factor that water companies needed to take into account in their pricing policies. The Tribunal found both those positions surprising.

43. The Authority's concern about regional average pricing appeared to be mainly based on a fear of some kind of "knock-on" effect in sectors not yet open to competition. The Tribunal was unpersuaded that that was a good reason for limiting the competitive opportunities now available to large industrial customers in the sector that has been opened to competition.

44. The Tribunal's conclusion on ECPR is that the ECPR approach in the Decision was not a safe methodology to use in this case for the purpose of determining the reasonableness of the First Access Price because: (i) the 'retail' price used in the calculation is not shown to be cost-related as regards the distribution element; (ii) the evidence strongly suggests that that price is itself excessive; (iii) the particular method of ECPR used in the Decision would eliminate the existing competition and in effect preclude virtually any competitive entry, because the resultant margins are insufficient; and (iv) the approach of the Authority to avoidable costs in its evidence and submissions was not the same as that in the Decision. None of the justifications advanced by the Authority for an ECPR approach persuaded the Tribunal that it could safely rely on the ECPR approach set out in the Decision in the circumstances of the present case.

*- Conclusions on excessive pricing*

45. For the above reasons, the Tribunal has reached the view that the Director's conclusion, that the First Access Price did not infringe the Chapter II prohibition as excessive, cannot be supported, either on an average accounting cost basis, or on the ECPR approach used in the Decision.

46. Dŵr Cymru submitted that the Tribunal needed to understand that if Albion's cost calculations were correct, Dŵr Cymru would need to seek the Authority's permission to raise its prices to every household customer in Wales. The Tribunal rejects that submission as both irrelevant and unfounded on the facts. In particular, non-potable revenues are a minor part of Dŵr Cymru's total revenues. Dŵr Cymru is a profitable

company which in 2006 decided to rebate some £24 million annually to its customers – some three times Dŵr Cymru's total annual non-potable revenue.

*- Margin squeeze*

47. As to Albion's complaint of a margin squeeze, it was not disputed that there was a margin squeeze within the meaning of the guidance given by the OFT and the European Commission, in that the margin between Dŵr Cymru's downstream retail price of 26p/m³ and its upstream First Access Price for common carriage of 23.2p/m³ would leave Albion with no effective margin, given that Albion also has to acquire the water from United Utilities at a price of at least 3p/m³.

48. In the Tribunal's view, there are four reasons why the analysis in the Decision is incorrect, or at least inadequate, on the issue of margin squeeze. (1) Since the First Access Price has not been shown to be related to the costs, and the evidence strongly suggests that price to have been excessive, it cannot be assumed that Dŵr Cymru's upstream price is a reasonable price. (2) The margin squeeze in question cannot be justified on the basis of an ECPR approach which is itself unsound, for the reasons already given. (3) The Decision does not deal adequately with the fact that Albion wishes to continue to combine the supply of water with its offer of water efficiency services. (4) The Director's approach in the Decision is contrary to the approach for determining the existence or otherwise of a margin squeeze under domestic and Community law.

49. Specifically in relation to water efficiency services, Albion has been supplying such services to Shotton Paper and has, the Tribunal was told, assisted Shotton Paper in improving its production efficiency in the use of water by some 20 per cent, although the international efficiency standard within the UPM Group has not yet been reached. Dŵr Cymru previously offered water efficiency services to major customers, but discontinued those services as a result of the Director's 1999 price determination. We were told that, as a result of the Director's 1999 price determination, the incidence of water efficiency management services offered to major customers by statutory water undertakers has declined by some 90 per cent.

50. The Authority came across as opposed to water undertakers offering water efficiency services to major customers, except on the basis of extra charges, and argued that such services did not fall within the "appointed activities" of water companies and did not benefit the wider community. The Tribunal rejects the Authority's arguments in law and on the basis of the Authority's own documents. In the Tribunal's view there is no basis for finding that the services offered by Albion to Shotton Paper are disproportionate to the needs of this very large customer, or that Shotton Paper should be required to pay more than it already does. In the Tribunal's view improved water efficiency not only increases Shotton Paper's international competitiveness, but also benefits the community in Wales more generally by conserving water resources and potentially reducing abstraction from the River Dee.

51. The Authority's stance of opposition to undertakers offering water efficiency services, and the apparent lack of weight it attached to such services, surprised the Tribunal, in view of public concern about the conservation of water resources, and in view of paragraphs 241 and 242 of the 2002 Consultation Paper which encourage water undertakers to supply such services.

52. The Authority's position that Albion, a statutory inset appointee offering water efficiency and retail services, and attempting to secure a better price for Shotton Paper, and perhaps Corus, through common carriage, was in no better position than a person who snatched a letter from the postman at the garden gate and demanded a margin for delivering the letter to the front door, entirely mischaracterised the facts of this case.

53. The Director's approach to the issue of margin squeeze in the Decision was contrary to the Guidance issued by the OFT, the Telecommunications Notice issued by the European Commission, the decision of the European Commission in *Deutsche Telekom*, and the Authority's own publication MD 163. In particular, the approach in the Decision did not identify separately the costs of the transportation service requested, and did not put the incumbent and the entrant on an equal footing.

54. The Director's approach, in the Decision, of basing the calculation of "avoidable costs" on the costs avoided in the short run as a result of supplying one less customer was not supported by the Authority's expert without qualification. The Authority's position

during the proceedings appeared to swing from arguing in the Decision that there were no avoidable costs, other than water resource costs, to arguing before the Tribunal that all retail costs were avoidable in the medium to longer term and fall to be deducted in the relevant retail-minus calculation. In those circumstances, and for the reasons given in paragraph 35 above, the Tribunal did not consider that the approach in the Decision to avoidable costs could safely be relied upon.

55. As already indicated, the approach in the Decision to "avoidable costs" would effectively preclude the introduction of common carriage and effectively deprive large users of water of the choice of an alternative supplier.

56. For those reasons the Tribunal finds that the Director's conclusion, at paragraph 352 of the Decision, that Dŵr Cymru did not infringe the Chapter II prohibition by engaging in a margin squeeze or "price squeezing" was erroneous in law and incorrect, or at least insufficient, from the point of view of the reasons given, the facts and analysis relied on, and the investigation undertaken.

- *The Costs Principle*

57. It was suggested in the Decision that the Director would have reached the same result had he been applying section 66E of the WIA91 which, although not in force at the time, sets out the "Costs Principle" to be applied when determining charges by undertakers to new suppliers who can now be licensed under that Act. There are two aspects to the construction of section 66E: (i) identifying the "starting point" figure for the calculation of the charge under section 66E(1)(b), (2), (3) and (5); and (ii) identifying the so-called "ARROW" costs to be deducted from the starting point figure under section 66E(4).

58. As to the starting point figure, what the undertaker may recover as the starting point under section 66E(1)(b) seems to the Tribunal to be: (i) the amount the undertaker could *reasonably* have expected to recover from the customers now being supplied by the licensee in respect of the *expenses*, including capital *expenses*, *reasonably* incurred or to be *reasonably* incurred by the undertaker in carrying out its functions; and (ii) a *reasonable* return on that amount (emphasis added). The result in the Tribunal's view

is that the amount to be recovered, and the constituent elements of that amount, must be cost-based and reasonable. The sum of those elements may equate to the prevailing retail price, but not necessarily.

59. In the present case, for the reasons already given, the retail price used in the ECPR calculation in the Decision has not been shown to be reasonably related to costs, and the evidence strongly suggests that price to be excessive. In those circumstances the Tribunal does not think it may safely be assumed, as the Director does at paragraphs 331 and 338 of the Decision, that the application in the present case of the Costs Principle set out in section 66E would give rise to the result arrived at by the Director in the Decision. To find otherwise would deprive the words "expenses", "reasonable" or "reasonably", used several times in that section, of any effective content.

60. As to ARROW costs, in the Tribunal's view an approach to the construction of section 66E(4) which, in effect, precludes virtually any effective competition or market entry, is in potential conflict with the consumer objective set out in section 2(2A)(a) and (2B) of the WIA91, and with the Chapter II prohibition, and is thus open to serious question.

61. In those circumstances the Tribunal does not consider that the references in paragraphs 317 to 338 of the Decision to the Costs Principle constitute a safe basis for upholding the result which the Director reached.

## XVI CONCLUSIONS

62. For the reasons given above we have reached the following conclusions:

(1) There is evidence before the Tribunal that the treatment cost of non-potable water on an average accounting cost basis was over-estimated in the Decision. However the Tribunal is prepared to assume, without deciding, that treatment costs are in the range 1.6p/m³ to 3.2p/m³.

(2) The matter of the "distribution" cost of non-potable water on an average accounting cost basis was not sufficiently investigated. In this respect the Decision is incorrect, or at least insufficient, from the point of view of the reasons given, the facts and analysis relied on, and the investigation undertaken, as regards in particular to the Director's conclusion in paragraph 302 of the

Decision to the effect that it was not unreasonable to assume that the "distribution" costs of potable and non-potable water are the same.

(3) The evidence strongly suggests that the First Access Price was excessive in relation to the economic value of the services to be supplied, by reason of the absence of any convincing justification for the "distribution" costs included in the average accounting cost calculation.

(4) The cross-check as to the validity of the First Access Price by reference to ECPR in paragraphs 317 to 331 of the Decision cannot be safely relied on because (i) the 'retail' price used in the calculation is not shown to be cost-related, as regards the distribution element; (ii) the evidence strongly suggests that that price was itself excessive; (iii) the particular method of ECPR used in this case would eliminate existing competition and, in effect, preclude virtually any competitive entry, because the margins are insufficient; and (iv) the approach of the Authority in its evidence and submissions was not the same as that in the Decision. None of the justifications for an ECPR approach advanced by the Authority persuaded us that we could safely rely on the approach set out in the Decision in the circumstances of the present case.

(5) As regards the allegation of margin squeeze, the existence of a margin squeeze was not seriously disputed. The Director's finding at paragraph 352 of the Decision that nonetheless there was no breach of the Chapter II prohibition was erroneous in law and incorrect, or at least insufficient, from the point of view of the reasons given, the facts and analysis relied on and the investigation undertaken.

(6) It is unsafe to assume, as the Director does in paragraphs 331 and 338 of the Decision, that the Costs Principle set out in section 66E of the WIA91 supports the conclusion which the Director reached in the Decision, since (i) the retail price used in the calculation in the Decision is not shown to have been reasonably cost-based, and the evidence strongly suggests that that price was itself excessive; and (ii) the Director's interpretation of ARROW costs under section 66E(4) is open to serious question, since that interpretation would on the evidence preclude virtually any effective competition or market entry, and give

rise to a potential conflict with the consumer objective under that Act and with the Chapter II prohibition.

63. It is now for the Tribunal to consider what consequential action, as regards orders and remedies, to take to conclude this case, having regard to the Tribunal's powers under paragraph 3(2) of Schedule 8 of the 1998 Act, together with any appropriate ancillary relief.

64. There is also the remaining issue of dominance and the associated question of essential facilities. In the Decision the Director was prepared to assume dominance, while expressing reservations as to whether Dŵr Cymru had a dominant position (paragraph 215). The Director did not believe that the Ashgrove system is an essential facility (paragraph 225). In recent submissions, the Authority has taken the stance that it is not yet in a position to take a final view on the issue of dominance which it considers to be outside the scope of the appeal. Dŵr Cymru adopts a similar position, and argues that how issues of dominance should be addressed, if at all, should be considered at a further case management conference. Both the Authority and Dŵr Cymru submit that it is not open to the Tribunal to make a finding of dominance under Schedule 8, paragraph 3(2)(e) of the Act. Albion submits that the issues of dominance and essential facilities are before the Tribunal and raised in the notice of appeal, and that the Tribunal can and should deal with them, if necessary by making the appropriate findings.

65. The Tribunal's present view is that it is highly unsatisfactory for the issue of dominance to be left as it is, and for the issue of dominance to have become "detached" from the issues relating to abuse. A good deal of evidence bearing on the issue of dominance that was not before the Director is now before the Tribunal. In those circumstances the Tribunal proposes to consider with the parties how the matter of dominance should now be handled. To facilitate that consideration, Annex A to this judgment summarises non-exhaustively matters potentially relevant to the issue of dominance and to the most appropriate course to adopt in that regard.

66. Those and any other relevant applications or matters will be considered by the Tribunal at a further hearing on a date to be notified.

Christopher Bellamy John Pickering Antony Lewis

Charles Dhanowa 6 October 2006
Registrar