



Neutral citation [2008] CAT 31

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

Case Number: 1046/2/4/04

Victoria House  
Bloomsbury Place  
London WC1A 2EB

7 November 2008

Before:

LORD CARLILE OF BERRIEW Q.C.  
(Chairman)  
THE HONOURABLE ANTONY LEWIS  
PROFESSOR JOHN PICKERING

Sitting as a Tribunal in England and Wales

BETWEEN:

**ALBION WATER LIMITED**  
**ALBION WATER GROUP LIMITED**

Appellants

-v-

**WATER SERVICES REGULATION AUTHORITY**

Respondent

- and -

**DŴR CYMRU CYFYNGEDIG**  
**UNITED UTILITIES WATER PLC**

Interveners

---

**JUDGMENT ON UNFAIR PRICING**

---

## **APPEARANCES**

Mr. Rhodri Thompson Q.C. and Mr. John O’Flaherty (instructed by Palmers Solicitors) appeared on behalf of the Appellants.

Mr. Rupert Anderson Q.C. and Miss Valentina Sloane (instructed by Pinsent Masons LLP on behalf of the Water Services Regulation Authority) appeared on behalf of the Respondent.

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

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

# TABLE OF CONTENTS

|              |  |           |
|--------------|--|-----------|
| <b>I.</b>    | <b>INTRODUCTION .....</b>  | <b>1</b>  |
|              | <i>The Tribunal's conclusions .....</i>                                    | <i>3</i>  |
| <b>II.</b>   | <b>LEGAL FRAMEWORK.....</b>  | <b>3</b>  |
|              | <i>Section 18: the Chapter II prohibition .....</i>                        | <i>3</i>  |
|              | <i>Section 60: principles to be applied in determining questions .....</i> | <i>4</i>  |
|              | <i>Jurisprudence and guidance on unfair pricing .....</i>                  | <i>4</i>  |
| <b>III.</b>  | <b>FACTUAL BACKGROUND.....</b>   | <b>7</b>  |
|              | <i>The parties and background.....</i>                                     | <i>7</i>  |
|              | <i>The Decision.....</i>   | <i>9</i>  |
|              | <i>The Notice of Appeal.....</i>   | <i>9</i>  |
|              | <i>The Tribunal's findings in its previous judgments .....</i>             | <i>9</i>  |
|              | <i>Dŵr Cymru's appeal.....</i>   | <i>11</i> |
| <b>IV.</b>   | <b>THE QUESTIONS REFERRED BACK TO THE AUTHORITY.....</b>                   | <b>12</b> |
| <b>V.</b>    | <b>THE REPORT TO THE TRIBUNAL .....</b>                                    | <b>12</b> |
|              | <i>AAC+ methodology.....</i>   | <i>14</i> |
|              | <i>LRIC methodology .....</i>  | <i>15</i> |
|              | <i>LAC methodology.....</i>  | <i>15</i> |
|              | <i>Results of the three methodologies.....</i>                             | <i>16</i> |
| <b>VI.</b>   | <b>PROCEDURE AND REMEDIES SOUGHT .....</b>                                 | <b>20</b> |
| <b>VII.</b>  | <b>THE TRIBUNAL'S GENERAL APPROACH .....</b>                               | <b>21</b> |
| <b>VIII.</b> | <b>THE APPLICABLE STANDARD OF REVIEW .....</b>                             | <b>22</b> |
|              | <i>Parties' submissions.....</i>   | <i>22</i> |
|              | <i>The Tribunal's analysis.....</i>  | <i>24</i> |
| <b>IX.</b>   | <b>THE EVIDENCE RELATING TO COSTS.....</b>                                 | <b>25</b> |
| <b>A.</b>    | <b>METHODOLOGY .....</b>   | <b>26</b> |
|              | <i>Background .....</i>  | <i>26</i> |
|              | <i>The Authority's approach.....</i>                                       | <i>26</i> |
|              | <i>Albion's submissions.....</i>   | <i>27</i> |
|              | <i>Dŵr Cymru's submissions.....</i>  | <i>28</i> |
|              | <i>The Authority's response.....</i>                                       | <i>29</i> |
|              | <i>The Tribunal's analysis .....</i>                                       | <i>29</i> |
|              | <i>AAC+ methodology.....</i>   | <i>31</i> |
|              | <i>LAC methodology.....</i>  | <i>33</i> |
|              | <i>LRIC methodology .....</i>  | <i>33</i> |
|              | <i>The Tribunal's conclusion.....</i>                                      | <i>34</i> |
| <b>B.</b>    | <b>COST OF CAPITAL .....</b>   | <b>35</b> |
|              | <i>Introduction.....</i>   | <i>35</i> |
|              | <i>Albion's submissions.....</i>   | <i>37</i> |
|              | <i>Dŵr Cymru's submissions.....</i>  | <i>37</i> |
|              | <i>The Authority's response.....</i>                                       | <i>38</i> |
|              | <i>The Tribunal's analysis.....</i>  | <i>38</i> |
| <b>C.</b>    | <b>COST OF SLUDGE DISPOSAL .....</b>                                       | <b>42</b> |
|              | <i>Introduction.....</i>   | <i>42</i> |
|              | <i>Albion's submissions.....</i>   | <i>43</i> |
|              | <i>Dŵr Cymru's submissions.....</i>  | <i>44</i> |

|      |  |    |
|------|--|----|
|      | <i>The Authority's response</i> .....  | 44 |
|      | <i>The Tribunal's analysis</i> .....   | 44 |
| D.   | <b>COST OF DISTRIBUTION PUMPING</b> .....  | 45 |
|      | <i>Introduction</i> .....  | 45 |
|      | <i>Albion's submissions</i> .....  | 46 |
|      | <i>Dŵr Cymru's submissions</i> .....   | 46 |
|      | <i>The Authority's response</i> .....  | 47 |
|      | <i>The Tribunal's analysis</i> .....   | 47 |
| E.   | <b>COST OF THE BACK-UP SUPPLY</b> .....  | 49 |
|      | <i>Introduction</i> .....  | 49 |
|      | <i>Albion's submissions</i> .....  | 49 |
|      | <i>Dŵr Cymru's submissions</i> .....   | 50 |
|      | <i>The Authority's response</i> .....  | 50 |
|      | <i>The Tribunal's analysis</i> .....   | 51 |
| X.   | <b>THE FIRST UNITED BRANDS QUESTION: WAS THE FIRST ACCESS PRICE EXCESSIVE?</b> .....   | 59 |
| XI.  | <b>THE SECOND UNITED BRANDS QUESTION: WAS THE FIRST ACCESS PRICE UNFAIR?</b> .....   | 62 |
| A.   | <b>PARTIES' SUBMISSIONS</b> .....  | 62 |
|      | <i>Albion's submissions</i> .....  | 62 |
|      | <i>Dŵr Cymru's submissions</i> .....   | 63 |
|      | <i>The Authority's response</i> .....  | 64 |
| B.   | <b>PRELIMINARY OBSERVATIONS ON UNFAIR PRICING</b> .....  | 65 |
| C.   | <b>THE ECONOMIC VALUE OF THE SERVICES TO BE SUPPLIED</b> .....   | 68 |
|      | <i>The extent of the sunk costs (and any intangible value) of the Ashgrove system</i> .....  | 72 |
|      | <i>The effects of the framework of economic regulation in place in 2000/01 and the social or economic desirability of regional average pricing</i> ..... | 76 |
|      | <i>The return on capital employed on the Ashgrove system compared with rates of return across similar industries</i> .....                               | 77 |
|      | <i>Should the economic value of the Ashgrove system reflect the cost of the back-up supply?</i> ....   | 78 |
| D.   | <b>WAS THE FIRST ACCESS PRICE UNFAIR?</b> .....  | 79 |
|      | <i>Was the First Access Price unfair in comparison to competing products?</i> .....  | 79 |
|      | <i>Was the First Access Price unfair in itself?</i> .....  | 81 |
| XII. | <b>CONCLUSION</b> .....  | 85 |

## I. INTRODUCTION

1. This appeal concerns the price for the partial treatment and transmission of non-potable water through an existing pipeline to a large paper factory on the North Wales coast. Despite the apparent simplicity of the concept of water flowing through a pipe, as will be seen below, the appeal has occupied many days of the time of the Tribunal, and the attention of the Court of Appeal. The issues of fact and law involved are far from simple. This judgment is longer than the Tribunal would have wished, and necessarily complex. Even as a specialist Tribunal, we would have liked to state the facts in a few paragraphs, and our reasoning and conclusion in not many more. Regrettably this has not been not possible.
2. The appeal arises from a Decision issued by the former Director General of Water Services<sup>1</sup>, now the Water Services Regulation Authority (“the Authority”) on 26 May 2004 (“the Decision”). The Decision concerned the proposed transport of water to be supplied by Albion Water Ltd (“Albion” or “the appellant”) to Shotton Paper Mill (“Shotton Paper”), which operates a paper mill in North Wales, using non-potable water<sup>2</sup> supplied through that part of the water pipe network belonging to Dŵr Cymru Cyfyngedig (“Dŵr Cymru”) known as the “Ashgrove system”. For the use of the Ashgrove system, in March 2001, Dŵr Cymru proposed to charge Albion an access price for partial treatment and common carriage of that non-potable water (referred to in these proceedings as the “First Access Price”) of 23.2p/m<sup>3</sup>. Albion complained that the First Access Price was so excessive as to amount to an abuse of a dominant position.
3. In the Decision, the Authority rejected Albion’s complaint that the First Access Price infringed the Chapter II prohibition contained in section 18 of the Competition Act 1998 (“the Act”), on the ground that Dŵr Cymru’s quoted price was not so excessive as to be unfair, and therefore unlawful.

---

<sup>1</sup> Since 1 April 2006 the functions of the Director have been assumed by the Authority pursuant to the provisions of the Water Act 2003. Where necessary, references in this judgment to the Authority are to be taken as referring to the Director and vice versa.

<sup>2</sup> Non-potable water is water that is of insufficient purity to be used as drinking, i.e. potable, water.

4. On appeal, the Tribunal has already found that parts of the Decision should be set aside for lack of reasoning and insufficient investigation (see the judgment of 6 October 2006 ([2006] CAT 23, [2007] CompAR 22) (hereafter “the main judgment”). For the reasons given in the judgment of 18 December 2006 [2006] CAT 36, [2007] CompAR 328 (“the further judgment”), the Tribunal found that Dŵr Cymru was dominant in what it considered to be the relevant market and, by quoting the First Access Price of 23.2p/m<sup>3</sup>, while at the same time offering retail supply at 26p/m<sup>3</sup>, had imposed on Albion a margin squeeze which constituted an abuse of a dominant position. To that extent, Albion’s appeal has already been allowed.
5. The Tribunal also decided to refer back to the Authority under rule 19(2)(j) of The Competition Appeal Tribunal Rules 2003 (S.I. No. 1372 of 2003) for further investigation the matter of the costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru, generally and through the Ashgrove system in particular, together with the associated question of whether, in the light of those costs, the First Access Price was an unfair price within the meaning of the Chapter II prohibition (see sub-paragraph (iii) of paragraph [360] of the further judgment).
6. On 18 June 2007 the Authority reported to the Tribunal that it had found the First Access Price to be excessive, since it exceeded the costs attributable to the services that Albion would have required in 2000/01 from Dŵr Cymru for its common carriage proposal. The Authority did not consider that the First Access Price was, on the balance of probabilities, unfair in itself and that it was not, therefore, an abuse of a dominant position. The Authority’s Report, together with the composite ‘Scott Schedule’ of the parties’ points of dispute in relation to the Report, is available on the Tribunal website (see paragraph [54] below).
7. This judgment sets out the Tribunal’s reasoning and conclusions on whether Dŵr Cymru has infringed the Chapter II prohibition by unfair pricing in the form of an excessive common carriage charge. In this judgment, we distinguish between a price that is “excessive” in terms of the distinction between the price and the cost of supply (including the cost of capital); and a price that is “unfair” and thus an abuse in that it bears no reasonable relation to the “economic value” of the services to be supplied. In

certain cases “economic value” may exceed the cost of supply where there are additional benefits not reflected in the costs of supply. An excessive price is therefore a necessary, but not sufficient, condition for an unfairly high price.

8. This Tribunal’s conclusions may be summarised as follows:
  - (a) The First Access Price specified by Dŵr Cymru in March 2001 materially exceeded the costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru, generally and through the Ashgrove system in particular.
  - (b) The economic value of the services to be supplied was not more, or not significantly more, than the costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru, generally and through the Ashgrove system in particular.
  - (c) The First Access Price bore no reasonable relation to the economic value of the services to be supplied, and had both an exclusionary and exploitative effect.
  - (d) The First Access Price was unfair in itself and therefore an abuse of Dŵr Cymru’s dominant position within the meaning of section 18, and in particular subsection 18(2)(a), of the Act.
9. In consequence of these conclusions, if necessary we shall hear further argument on the questions of relief and costs.

## **II. LEGAL FRAMEWORK**

### *Section 18: the Chapter II prohibition*

10. Section 18(1) of the Act provides that any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom. The prohibition imposed by section 18 is closely modelled on Article 82 of the Treaty establishing the European Community and is known as the “Chapter II prohibition”: section 18(4).

11. Section 18(2) gives a non-exhaustive list of examples of what may constitute abuse of a dominant position. Of particular importance for present purposes is sub-paragraph (a) which provides that conduct may constitute an abuse if it consists in a dominant undertaking “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions”.
12. Section 18 does not spell out the consequence of an abuse of a dominant position (in contrast to section 2(4) which applies to prohibited agreements). There can be little doubt, however, that a quoted access price, insofar as it is abusive within the meaning of the Chapter II prohibition, is unlawful.

*Section 60: principles to be applied in determining questions*

13. Section 60 of the Act provides that questions arising in relation to competition within the United Kingdom are, so far as possible and having regard to any relevant differences, dealt with in a manner which is consistent with the treatment of corresponding questions in Community law: section 60(1). Similarly the Tribunal must decide any such question in a manner consistent with any relevant decision of the Court of First Instance and the European Court of Justice (“the CFI” and “the ECJ” respectively or, together, “the Community Courts”): section 60(2). The Tribunal must, in addition, have regard to any relevant decision or statement of the European Commission: section 60(3).

*Jurisprudence and guidance on unfair pricing*

14. It is well-established that excessive pricing can be “unfair” and thus an abuse of a dominant position. The seminal judgment in this area of law is that of the ECJ in Case 27/76 *United Brands v Commission* [1978] ECR 207 (“*United Brands*”). In that case, the ECJ considered whether the selling price imposed by a banana trader in a dominant position was excessive and thus amounted to an abuse. The ECJ held:

“249. It is advisable therefore to ascertain whether, in imposing that price, the undertaking has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been what is referred to as normal and sufficiently effective competition.”



15. At paragraphs [250] to [253] the ECJ continued as follows:

“250. In this case charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse.

251. This excess could, inter alia, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production, which would disclose the amount of the profit margin; however the Commission has not done this since it has not analysed [United Brand’s] costs structure.

252. The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products.

253. Other ways may be devised – and economic theorists have not failed to think up several – of selecting the rules for determining whether the price of a product is unfair.”

16. Given the imperative in section 60 of the Act to ensure a high degree of consistency between the interpretation of the European Community and domestic competition law provisions, section 18, like Article 82 EC, must be interpreted by reference to its purpose (see to that effect, *Case 6/72 Europemballage and Continental Can v Commission* [1973] ECR 215, [1973] CMLR 199, paragraphs [22]-[26]). When considering the test to be applied for excessive pricing under Article 82 EC in *Attheraces Ltd v The British Horseracing Board Ltd* [2007] EWCA Civ 38, [2007] UKCLR 309 (“*Attheraces*”), the Court of Appeal said at paragraph [119]:

“the law on abuse of dominant position is about distortion of competition and safeguarding the interests of consumers in the relevant market. It is not a law against suppliers making “excessive profits” by selling their products to other producers at prices yielding more than a reasonable return on the cost of production, i.e. at more than what the judge described as the “competitive price level”. Still less is it a law under which the courts can regulate prices by fixing the fair price for a product on the application of the purchaser who complains that he is being overcharged for an essential facility by the sole supplier of it”.

17. The Office of Fair Trading (“the OFT”) has published draft guidance entitled “Assessment of Conduct” (OFT 414a, April 2004). This describes the anti-competitive harm arising from excessive prices as follows:

“2.3 Not only might excessively high prices be exploitative but they may also harm competition. For example, an undertaking dominant in the supply of an important input might well be in a position to set excessive prices which make it

more difficult for undertakings that require the input to enter or to compete in related markets.

2.4 Excessive prices may also be a sign that the process of competition is not working effectively. This would be the case, in particular, where a dominant undertaking combines excessive prices with exclusionary behaviour designed to protect its ability to maintain those excessive prices. In this case, both practices could be found abusive.”

18. In Decision No. CA98/2/2001 of 30 March 2001 *Napp Pharmaceutical Holdings Limited and subsidiaries* [2001] UKCLR 597 the former Director General of Fair Trading attached importance to whether the price was above that which would exist in a competitive market, in circumstances where there was no effective pressure to bring prices down to competitive levels. A similar approach to questions about excessive pricing is taken by the OFT in paragraph 2.6 of the draft guidance. On appeal, in *Napp Pharmaceutical Holdings Limited v Director General of Fair Trading* [2002] CAT 1, [2002] CompAR 13 (“*Napp*”) the Tribunal did not dissent from that approach: see paragraphs [390] to [391] of the final judgment.
19. Another way of assessing whether the price charged is unfair, in the terms of paragraph [253] of the judgment in *United Brands*, is by reference to what is charged for the product in question in a comparable competitive market (see Case 30/87 *Bodson v Pompes Funèbres des Régions Libérées* [1988] ECR 2479, [1989] 4 CMLR 984; see also the OFT’s draft guidance paragraph 2.7).
20. In this judgment, the Tribunal follows the approach set out by the Court of Justice in *United Brands*. The ECJ identified several steps to establishing an unfairly high price which may be summarised as follows:
  - (a) an analysis of the costs incurred in producing the product or service;
  - (b) a comparison of those costs with the price charged and an assessment of whether the resulting difference, i.e. the profit, is such that the price charged is excessive; and if so
  - (c) an assessment of whether the excessive price bears no reasonable relation to the economic value of the product or service supplied and is an abuse of a dominant position, with the consequence that it is either:

- (i) unfair in itself; or
- (ii) unfair when compared with competing products.

21. The above approach has consistently been applied by the Commission of the European Communities, the OFT, the Tribunal and the Court of Appeal.

### **III. FACTUAL BACKGROUND**

22. The full facts of the case are recited in the Tribunal's main judgment of 6 October 2006, in particular, paragraphs [62] to [212]. The facts set out in this judgment are restricted to those necessary to understand the decision of this Tribunal on whether Dŵr Cymru has infringed the Chapter II prohibition by unfair pricing in the form of an excessive common carriage price.

#### *The parties and background*

23. Dŵr Cymru is the water undertaker, appointed under section 6 of the Water Industry Act 1991, for an area comprising most of Wales and certain adjoining parts of England. Dŵr Cymru supplies non-potable water to its industrial customers through a series of discrete water supply systems. In broad terms, those customers were supplied under "special agreements", under which each customer typically paid a negotiated charge. There was, at the material time, no relevant regulation of the retail prices of non-potable water to large industrial customers in Wales using more than 250 Ml per annum (see the main judgment at paragraphs [169] to [174], [617] to [622], and [750]).

24. Albion is an inset appointee for a specific geographic area on Deeside, in Flintshire, North Wales. Its customer is Shotton Paper, a plant owned by UPM-Kymmene (UK) Limited, to which it supplies both potable and non-potable water. In both value and volume, the non-potable supply greatly exceeds the potable supply. Shotton Paper is supplied with non-potable water via the Ashgrove system, which is owned by Dŵr Cymru. The Ashgrove system is a single pipeline, from the River Dee at Heronbridge, via a water treatment works, to two large customers: Shotton Paper and, the steel producer, Corus (which owns a steelworks nearby). (Paragraph [84] of the main judgment contains a more detailed description of the Ashgrove system.)

25. To enable Albion to obtain water for supply to Shotton, it entered into a supply agreement with Dŵr Cymru in March 1999 (known as the “Second Bulk Supply Agreement”). Under that agreement, water supplied to Shotton was extracted by United Utilities and then purchased by Dŵr Cymru which (partially) treated and transported it via the Ashgrove system to the boundary of Shotton’s premises. Albion originally agreed to pay Dŵr Cymru a price of 26p/m<sup>3</sup> for this service, including the cost of the water. Albion re-sold the water to Shotton at the same price of 26p/m<sup>3</sup>. The retail price then offered to Shotton Paper by Dŵr Cymru – 26p/m<sup>3</sup> – was therefore exactly the same as the bulk supply price offered to Albion.
26. The terms on which Dŵr Cymru currently supplies Albion are set by an interim Order of the Tribunal under which Albion is charged 3.55p/m<sup>3</sup> less than it would otherwise have been charged under the Second Bulk Supply Agreement (see section X of the further judgment).
27. The evidence is that the Second Bulk Supply Agreement was only intended to be temporary. Dŵr Cymru and Albion have been in negotiation since November 2006 regarding the terms of a new bulk supply agreement using the Ashgrove system. We understand this negotiation remains ongoing.
28. In 2000, Albion proposed to purchase water direct from United Utilities at Heronbridge (thereby cutting out ownership of the water at any stage by Dŵr Cymru), and to resell the water to Shotton Paper, paying Dŵr Cymru a reasonable price for transmission of the water through the Ashgrove system. Albion submitted that this common carriage arrangement would enable it to pass on to Shotton Paper a significant saving in the price of water. On 28 September 2000 Albion requested Dŵr Cymru to quote a common carriage price for use of the Ashgrove system. On 2 March 2001 Dŵr Cymru quoted Albion an access price of 23.2p/m<sup>3</sup> for the common carriage services requested for the year 2000/01. This is what has become known as the First Access Price.
29. On 8 March 2001 Albion complained to the Director that the First Access Price constituted an infringement of the Chapter II prohibition.

### *The Decision*

30. On 26 May 2004 the Director rejected Albion's complaint on the ground, in part, that the price quoted by Dŵr Cymru was not so excessive as to be unfair, and hence an abuse of a dominant position in breach of the Chapter II prohibition. In deciding this matter, the Authority used an approach based on Average Accounting Costs ("AAC"). The AAC approach started with Dŵr Cymru's total average revenues from all its customers (potable and non-potable) and then derived, in the series of steps described at paragraphs 250-307 of the Decision, the price for the common carriage of non-potable water through the Ashgrove system, on a "whole company" AAC basis.
31. In the Decision, although it found certain cost misallocations on the part of Dŵr Cymru (particularly as regards treatment costs), the Authority rejected the assertion that the First Access Price bore no reasonable relation to the economic value of the service provided, when judged by reference to the relationship of the costs actually incurred by Dŵr Cymru to the price charged. The Authority therefore concluded that Dŵr Cymru did not abuse a dominant position in breach of the Chapter II prohibition by engaging in excessive pricing.

### *The Notice of Appeal*

32. By its Notice of Appeal dated 23 July 2004 (amended on 5 June 2006), Albion submitted that the First Access Price of 23.2p/m<sup>3</sup> bore "no reasonable relation to the economic value of the product supplied" and therefore amounted to an abuse of dominant position. At paragraph 217(b) of the Notice of Appeal, Albion specifically requested the Tribunal to decide whether Dŵr Cymru had breached the Chapter II prohibition by providing an anti-competitive access price.

### *The Tribunal's findings in its previous judgments*

33. In its main judgment of 6 October 2006 and further judgment of 18 December 2006, the Tribunal made the following findings which are the necessary background to this judgment, and to the question of unfair pricing now before us:

- (a) Dŵr Cymru held a dominant position in the market for the transportation and partial treatment<sup>3</sup>, via the Ashgrove system, of water abstracted from the Heronbridge abstraction point for supply to Shotton Paper and Corus.
- (b) The “distribution” cost of non-potable water to Shotton Paper, on an AAC basis, was not sufficiently investigated.
- (c) There are significant differences between the non-potable and potable water supply systems under consideration in this case.
- (d) It was not therefore reasonable for Dŵr Cymru (or the Authority) to assume that the costs of “distribution” of non-potable and potable water were the same at 16p/m<sup>3</sup>.
- (e) There is nothing inherently inappropriate in a “top-down” approach to establishing AAC (i.e. to considering Dŵr Cymru’s costs on a “whole-company” approach and working downwards), assuming reliable information had been obtained and proper accounting procedures followed.
- (f) Any such “top-down” approach needs to be subject to appropriate verification. The obvious cross-check in such a context is a “bottom-up” calculation which, in this case, should ascertain the actual costs of the Ashgrove system.
- (g) The Efficient Component Pricing Rule was not a safe methodology to use for the purpose of determining the reasonableness of the First Access Price.
- (h) The evidence before the Tribunal regarding actual costs, incurred or attributable, strongly supported Albion’s contention that both the distribution cost of 16p/m<sup>3</sup>, and the total cost of 19.2p/m<sup>3</sup>, on an AAC basis, were not related to “the costs actually incurred” by Dŵr Cymru and accordingly were excessive. The First Access Price of 23.2p/m<sup>3</sup> had not, on the evidence then available to the Tribunal, been shown to be reasonably related to the actual costs of supply.

---

<sup>3</sup> There was evidence before the Tribunal which indicated that the treatment costs should be in the range of 1.6p/m<sup>3</sup> to 3.2p/m<sup>3</sup> (see section IX of the main judgment).

- (i) The evidence taken as a whole strongly suggested to the Tribunal 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 level of “distribution” costs included in the AAC calculation.
  - (j) The level 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 return on capital. This, in itself, provided strong evidence that the First Access Price was not sufficiently cost based and was excessive.
  - (k) In the light of the foregoing, the Decision that the First Access Price did not infringe the Chapter II prohibition was incorrect.
  - (l) By quoting the First Access Price of 23.2p/m<sup>3</sup>, at the same time as offering a retail price of 26p/m<sup>3</sup>, Dŵr Cymru imposed on Albion a margin squeeze which constituted an abuse of a dominant position contrary to the Chapter II prohibition.
34. In its further judgment the Tribunal stated that it was “very close” to reaching a conclusion on the question of excessive pricing on the evidence then before it. However, that question would only be determined once the Tribunal had the benefit of the results of further work by the Authority, and once the parties had been given an opportunity to make submissions on it.

*Dŵr Cymru’s appeal*

35. On 2 February 2007 the Tribunal refused an application by Dŵr Cymru for permission to appeal against the main and further judgments.
36. On 5 April 2007 Richards LJ refused permission to appeal on the papers: [2007] UKCLR 1577. On 26 July 2007, following an oral hearing, the Court of Appeal granted Dŵr Cymru permission to appeal from the main and further judgments on two points of law, concerning margin squeeze and the Tribunal’s jurisdiction to make a finding of dominance.

37. On 22 May 2008 the Court of Appeal dismissed Dŵr Cymru’s appeal: [2008] EWCA Civ 536, [2008] UKCLR 457. The Court held that the Tribunal was correct to direct itself by reference to the test of margin squeeze as formulated in the relevant guidance and the case-law (see paragraphs [87] to [111]). In addition, the Court held that the Tribunal had jurisdiction to make the decision it did under paragraph 3(2)(e) of Schedule 8 to the Act, namely that Dŵr Cymru had a dominant position in the relevant market at the material time (see paragraphs [112] to [128]).

#### **IV. THE QUESTIONS REFERRED BACK TO THE AUTHORITY**

38. The Tribunal referred back to the Authority, under rule 19(2)(j) of the Tribunal Rules, for further investigation the following issues (see paragraphs [240] to [281] of the further judgment):
- (a) The costs reasonably attributable to the service of the transportation and partial treatment of non-potable water by Dŵr Cymru generally;
  - (b) The costs reasonably attributable to the service of the transportation and partial treatment of non-potable water by Dŵr Cymru through the Ashgrove system, in particular;
  - (c) Whether, in the light of those costs, the First Access Price was an unfair price within the meaning of the Chapter II prohibition.

#### **V. THE REPORT TO THE TRIBUNAL**

39. On 18 June 2007, the Authority lodged its Report with the Tribunal, in which it concluded that the First Access Price was excessive (since it exceeded the costs attributable to the relevant services by a material extent); but that there was insufficient evidence that the First Access Price bore no reasonable relation to the economic value of the service provided. Accordingly, the Authority found that the First Access Price, though excessive, was not unfair within the relevant legal test, and therefore its imposition did not amount to an abuse of a dominant position.
40. In its Report, the Authority first sought to identify the services Albion reasonably required in 2000/01 from Dŵr Cymru for its common carriage proposal. Only those



services required for common carriage on the Ashgrove system were included as costs that could be defined as “reasonably attributable” (Report, paragraph 6.15). On this basis, it said the services which Dŵr Cymru would have provided to Albion under a common carriage arrangement in 2000/01 and which would comprise the First Access Price were as follows:

- Transport of Albion’s water via the raw water aqueduct from Heronbridge to the Ashgrove Water Treatment Works.
- Partial treatment of Albion’s water at the Ashgrove Water Treatment Works.
- Disposal of the sludge created by partially treating Albion’s water via a sludge main to the Chester Sewage Treatment Works.
- Transport of Albion’s water via Dŵr Cymru’s non-potable bulk distribution main from the Ashgrove Water Treatment Works to Shotton Paper.
- Management of the Ashgrove system via water storage in the Corus lagoons.
- Operational control of the Ashgrove system.
- A back-up supply for Albion’s non-potable water supply to Shotton Paper.
- Common carriage services (operational and customer services including a system for “unders and overs” and Albion-specific customer services).

Source: Report, paragraph 5.103.

41. In order to make a comparison between the First Access Price and the costs reasonably attributable to the services which are assumed to be included in the First Access Price, the Authority used three methodologies to calculate the relevant costs: an average accounting costs plus (“AAC+”) approach; a long-run incremental cost (“LRIC”) approach; and a local accounting costs (“LAC”) approach which, as paragraph 9.4 of the Report explains, is more accurately described as a local hybrid costs approach (since it draws on the results of the AAC+ methodology as and when local accounting costs are not available). The Authority explained why it chose the three methodologies in section 6 of the Report. It noted that all three methodologies were more locally cost

based than the AAC methodology originally used by Dŵr Cymru to justify the First Access Price.

42. Before we set out the results of the Authority's further investigation, we describe in greater detail the methodologies which the Authority used.

*AAC+ methodology*

43. The AAC methodology is traditionally used in the water industry to set non-discriminatory (retail) prices for different customer classes. As already noted, an AAC calculation is based on the revenues received by the whole company from all its customers (using revenue figures as a proxy for costs). It typically uses a "top-down" approach to establishing average accounting costs, i.e. it starts with average revenues generally and then seeks to identify the variation in costs of supplying particular classes of customer.
44. In its main judgment the Tribunal found that, if access prices are arrived at on an AAC basis, it should nonetheless be possible to verify the costs in question or at least identify the components of costs on an estimated basis (see paragraph [470]). Similarly, if the approach used is such that the components of costs cannot be identified or verified, then as regards the discrete non-potable systems, such as the Ashgrove system, there is a risk of price discrimination: see paragraphs [624]-[625] of the main judgment. However, the Tribunal also accepted, at paragraph [605], that it would still be necessary to use company-wide average figures to a large extent.
45. For its further work, the Authority took the pure AAC methodology and adapted it. This "average accounting cost plus approach" (AAC+) sought to obtain "a greater level of granularity of the costs associated with common carriage" (Report, paragraph 6.9). For example, bulk water distribution is now split into a number of different sub-functions: pumping, storage, mains and customer interface (Report, paragraph 7.5). This methodology allocates costs to different customer groups to make tariffs cost reflective, thereby providing a basis for testing the fairness of the First Access Price.

46. The AAC+ methodology was developed by the Authority, in consultation with the parties, from a draft tariff model submitted by Dŵr Cymru in 2006. Using regulatory costs from 2000/01, the AAC+ methodology comprises four steps which are as follows:
- (a) The allocation of company regulatory accounting costs into functional activities;
  - (b) The allocation of functional costs across customer classes by headline cost drivers;
  - (c) The application of customer class “cost” weighting factors; and
  - (d) The application of customer class “income risk” weighting factors to correct for underlying customer class revenue risk differentials.

These four steps are described in detail in section 7 of the Report.

#### *LRIC methodology*

47. LRIC estimates the amount by which long-run capital and operating costs change when output changes by a substantial and defined amount (commonly known as the “increment”). It is an acknowledged regulatory methodology and has been widely used in other regulated industries. The Authority commented that it is closely related to the concept of Long Run Marginal Cost. It used LRIC as a cross-check against its preferred methodology, namely AAC+ (Report, paragraph 6.18), especially to indicate a “floor” price above which charges would not be considered predatory. In this case, the Authority used the LRIC methodology to estimate the cost of supplying a substantial increment in demand for non-potable water under circumstances where additional capacity would be required. It is briefly described in paragraphs 6.18-6.29 of the Report and in more detail in section 8.

#### *LAC methodology*

48. The Authority endeavoured to produce a local estimate of the costs reasonably attributable to using the Ashgrove system. Under the LAC methodology Dŵr Cymru’s local costs were calculated for the raw water aqueduct, together with the costs of the partial treatment, distribution and storage functions associated with the Ashgrove system. LAC is not a methodology that the Authority had traditionally employed in a

regulatory context since the Authority regulates prices on a regional average basis. Where local (regulatory) costs were not available, the Authority asked the parties to provide justification for the assumptions they proposed and used alternative techniques to estimate local costs. In consequence, the Authority noted that the term “accounting” in LAC is not an accurate description of the methodology actually adopted. A more accurate description, it said, would be “local hybrid costs”, a method of calculation that attempts to identify local costs wherever possible but also draws on the results of AAC+ where such information is not available. The LAC methodology is described in more detail in section 9 of the Report.

*Results of the three methodologies*

49. The Authority calculated the unit costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru, generally (AAC+) and through the Ashgrove system in particular (LRIC/LAC), to be as follows:

| Cost components   | Methodology              |                          |                         |
|---|--------------------------|--------------------------|-------------------------|
|   | AAC+<br>p/m <sup>3</sup> | LRIC<br>p/m <sup>3</sup> | LAC<br>p/m <sup>3</sup> |
| Raw water aqueduct  | 1.2                      | 0.0                      | 0.1                     |
| Water treatment (including sludge management*)  | 5.3                      | 9.3                      | 4.4                     |
| Bulk non-potable distribution   | 2.3                      | 9.9                      | 2.5                     |
| Water storage   | 1.0                      | 0.0                      | 1.3                     |
| Operational control   | 0.3                      | 0.8                      | 1.1                     |
| Management, general and support expenditure   | 2.1                      | n/a                      | 2.8                     |
| Business activities (i.e. regulatory services, scientific services, bad and doubtful debts and local authority rates) | 2.4                      | n/a                      | 1.4                     |
| Back-up supply  | 4.4                      | n/a                      | 4.4                     |
| Common carriage services  | 0.3                      | n/a                      | 0.3                     |
| <b>Total</b>  | <b>19.3</b>              | <b>20.0</b>              | <b>18.5**</b>           |

Source: Report, paragraphs 1.14 and 10.1

\* The results of the LRIC and LAC methodologies are contained in Tables 17 and 20 of the Report. Those tables indicate that the treatment costs reasonably attributable to sludge management were 1.9p/m<sup>3</sup> and 1.4p/m<sup>3</sup> respectively.

\*\* The note to paragraph 1.14 of the Report explained that the LAC figures do not add up exactly due to rounding.

50. Using the same sequence of questions outlined in paragraph [38] above, we set out below a summary of the answers the Authority provided in response to the questions referred to it by the Tribunal. The answers were given by reference to the information available, and the circumstances prevailing, at the time at which the First Access Price was offered, namely the year 2000/01, but were further revised by the Authority in response to the parties' submissions in relation to the Report.

(a) *The costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru generally*

The cost estimates used in the Authority's AAC+ methodology represented the regional *average* costs attributable to the service of the transportation and partial treatment of water by Dŵr Cymru to large non-potable customers generally, except for the cost of the back-up supply. The cost of the back-up supply was included in the AAC+ methodology in order to calculate the costs reasonably attributable to the same service through the Ashgrove System in particular (see (b) below). The costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru generally can therefore be calculated by deducting the cost of the back-up supply (4.4p/m<sup>3</sup>) from the total costs calculated pursuant to the AAC+ methodology contained in Table 16 of the Report (19.3p/m<sup>3</sup>) as shown in the following table:

| <b>Methodology</b> | <b>Result of methodology in the Report</b> | <b>First Access Price</b> | <b>Percentage by which the First Access Price exceeds cost</b> |
|--------------------|--|---------------------------|--|
| AAC+               | 14.9p/m <sup>3</sup>                       | 23.2p/m <sup>3</sup>      | 55.7%  |

In the light of the parties' points of dispute (contained in the 'Scott Schedule' available on the Tribunal's website), the Authority refined its position on the AAC+ methodology. Those refinements related to the inclusion of water distribution pumping (2.0p/m<sup>3</sup>); sludge disposal (0.3p/m<sup>3</sup>); stranded non-potable assets (0.2p/m<sup>3</sup>); and the capital cost weighting factors for non-potable water treatment, which were reduced in order to account for a profit attribution cost weighting factor based on "throughput" in 2000-01 (-0.6p/m<sup>3</sup>) and lower capital maintenance expectations (-0.6p/m<sup>3</sup>). The net results of these changes are shown in the table below:

| <b>Methodology</b> | <b>Revised result of methodology*</b> | <b>First Access Price</b> | <b>Percentage by which the First Access Price exceeds cost</b> |
|--------------------|---------------------------------------|---------------------------|--|
| AAC+               | 16.1p/m <sup>3</sup>                  | 23.2p/m <sup>3</sup>      | 44.1%  |

\* Paragraph 19 of the Response of the Authority of 18 December 2007 indicated that the revised result for the AAC+ methodology should be 20.5p/m<sup>3</sup>, taking into account the fact that the figures were rounded. However, the above table reflects the deduction of the cost of the back-up supply.

- (b) *The costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru through the Ashgrove system, in particular (see (c) below)*

In the Report the Authority presented the results based on the costs of the Ashgrove system using the AAC+, LRIC and LAC methodologies as follows:

| <b>Methodology</b> | <b>Result of methodology in the Report</b> | <b>First Access Price</b> | <b>Percentage by which the First Access Price exceeds cost</b> |
|--------------------|--|---------------------------|--|
| AAC+               | 19.3p/m <sup>3</sup>                       | 23.2p/m <sup>3</sup>      | 20.2%  |
| LRIC               | 20.0p/m <sup>3</sup>                       | 23.2p/m <sup>3</sup>      | 16.0%  |
| LAC                | 18.5p/m <sup>3</sup>                       | 23.2p/m <sup>3</sup>      | 25.4%  |

In the light of the parties' further representations, the Authority refined its position on all three methodologies. The adjustments to the AAC+ calculations were outlined in (a) above. The Authority refined its position on the LAC methodology in relation to a correction in the Modified Acquisition Cost ("MAC")<sup>4</sup> conversion factor: up from 12.0% to 12.3% (0.1p/m<sup>3</sup>); an adjustment to the unit cost for sludge disposal (0.2p/m<sup>3</sup>); inclusion of stranded non-potable assets as an additional common business cost (0.2p/m<sup>3</sup>); and an increase in the gross Modern Equivalent Asset Value ("MEAV") for water treatment capital costs (0.2p/m<sup>3</sup>). The Authority also refined its position on the LRIC methodology, in particular in relation to the calculation of the costs of sludge disposal (0.2p/m<sup>3</sup>) and water treatment capital costs (0.6p/m<sup>3</sup>). The net results of the changes are shown in the table below:

| <b>Methodology</b> | <b>Revised result of the methodology</b> | <b>First Access Price</b> | <b>Percentage by which the First Access Price exceeds cost</b> |
|--------------------|--|---------------------------|--|
| AAC+               | 20.5p/m <sup>3</sup>                     | 23.2p/m <sup>3</sup>      | 13.2%  |
| LRIC               | 20.8p/m <sup>3</sup>                     | 23.2p/m <sup>3</sup>      | 11.5%  |
| LAC                | 19.2p/m <sup>3</sup>                     | 23.2p/m <sup>3</sup>      | 20.8%  |

(c) *Whether, in the light of those costs, the First Access Price was an unfair price within the meaning of the Chapter II prohibition*

The Authority concluded that the First Access Price was excessive since it exceeded the costs attributable to the relevant services to a material extent. The Authority did not consider that there was cogent evidence, in the circumstances of this case, that the excess was, on the balance of probabilities, unfair in itself. The

<sup>4</sup> The MAC for the Ashgrove system was initially calculated by applying the ratio between Modern Equivalent Asset Value and "Regulatory Capital Value" ("RCV") at company level for water supply by Dŵr Cymru (12%) to allow for the capital value discount at privatisation; see paragraph 6.39 of the Report.

Authority, while recognising that the matter was ultimately one for the Tribunal to determine, advised that there was insufficient evidence that the First Access Price bore no reasonable relation to the economic value of the service provided and so made no finding that the First Access Price was unfair within the meaning of the test set out by the ECJ in *United Brands*.

## **VI. PROCEDURE AND REMEDIES SOUGHT**

51. The relevant procedural background to this case is set out in section VII of the main judgment.
52. In February 2007, Sir Christopher Bellamy Q.C. left the Tribunal. Subsequently, Marion Simmons Q.C. was appointed to replace him as chair of this Tribunal panel.
53. On 18 June 2007 the Authority reported the results of its further investigation to the Tribunal. The Authority's Report is available on the Tribunal website.
54. A case management conference took place on 23 October 2007. Upon the parties indicating that they were content for the Tribunal to proceed to determine the unfair pricing issue pending judgment by the Court of Appeal in *Dŵr Cymru Cyfyngedig v Albion Water Limited*, the Tribunal directed the parties to raise their points of dispute in relation to the Report in the form of a joint Schedule. A composite 'Scott Schedule' of Albion's and Dŵr Cymru's points of dispute and the Authority's response was filed on 18 December 2007 and is available on the Tribunal's website. A hearing took place on 14-15 February 2008.
55. On 2 May 2008, Marion Simmons Q.C. died. The present Tribunal panel would like to express its appreciation of the part she played in these proceedings. Following her death, it was agreed by all the parties that the Tribunal panel should be reconstituted and continued under a new Chairman. On 7 May 2008 the President appointed Lord Carlile of Berriew Q.C. as Chairman. The parties were content for the Tribunal, thus constituted, to consider the unfair pricing issue and give judgment by reference to the papers, and transcripts of all the hearings. Lord Carlile has taken the opportunity to read



and consider that large volume of material: this has caused some delay, but, we hope, a minimum of inconvenience.

56. On 22 May 2008 the Court of Appeal handed down its judgment in *Dŵr Cymru Cyfyngedig v Albion Water Limited*, *Water Services Regulation Authority (formerly Director General of Water Services), Office of Fair Trading, Office of Communications* [2008] EWCA Civ 536, [2008] UKCLR 457 rejecting Dŵr Cymru's appeal against the Tribunal's main and further judgments.
57. As the remaining issue in this case, Albion claimed that the Tribunal should decide that, by quoting the First Access Price of 23.2p/m<sup>3</sup>, Dŵr Cymru had imposed on Albion a price so excessive as to constitute an abuse of a dominant position. Albion asserted the extent of such excess was in the range of 11p/m<sup>3</sup> to 15p/m<sup>3</sup>.
58. The Authority submitted that the task for the Tribunal was to decide what weight to attach to the Report, in the light of the evidence as it stands and the Court of Appeal's determination, in order to reach its own view on the unfair pricing issue.
59. Dŵr Cymru asserted that the Tribunal should dismiss the remainder of Albion's appeal.

## **VII. THE TRIBUNAL'S GENERAL APPROACH**

60. The Authority did not provide the parties or the Tribunal with all its detailed calculations, or the full evidence supporting the findings contained in its Report. The Authority claimed that it would not have been conducive to the expeditious conduct of these proceedings for the parties or the Tribunal to attempt to undertake fresh calculations or sensitivity checks by reference to raw data, alternative methodologies or differences of approach on issues which necessarily require evaluation and the exercise of judgment. In the Tribunal's judgment, a report prepared pursuant to rule 19 of the Tribunal Rules should enable all connected with the proceedings to ascertain clearly the reasons for the conclusions of the authority in question.
61. All the parties emphasised at the hearing that they relied not only on the points made in their oral submissions, but also on the points raised in their earlier pleadings, witness statements and skeleton arguments. No additional statements from witnesses of fact or

expert witnesses were served relating to the unfair pricing issue. The Tribunal has carefully considered all the written material submitted by the parties as well as the oral arguments, in arriving at the conclusions set out in this judgment.

62. In this judgment, the Tribunal has had regard to the remarks of the Court of Appeal in *Dŵr Cymru Cyfyngedig v Albion Water Ltd*, paragraph [56] above, regarding the length of the earlier judgments in this case.
63. When considering the parties' submissions in relation to the calculation of costs, we accept, as urged upon us by the Authority, that the Tribunal, in this judgment, should focus on important points of principle. We therefore offer our reasons only in such detail as is necessary to demonstrate the principles on which we have acted and the reasons that have led to our decision on the merits of the case (see *Argos Ltd v Office of Fair Trading* [2006] EWCA Civ 1318, [2006] UKCLR 1135, paragraph [5]).

#### **VIII. THE APPLICABLE STANDARD OF REVIEW**

64. In giving our judgment we bear closely in mind the particular position of the Authority. It is a responsible, statutory public authority charged with a duty to act in the public interest. The views of the Authority should carry proper weight and the Tribunal will always reflect fully upon them. These observations prompt the question how intensive should be this Tribunal's review of a report prepared by the Authority pursuant to rule 19 of the Tribunal Rules?

##### *Parties' submissions*

65. The parties were unable to agree upon the correct standard of review in this case. Three approaches were canvassed.
66. The first employs the principles of judicial review, which counsel for Dŵr Cymru argued the Tribunal should apply. He drew an analogy with the position under section 193 of the Communications Act 2003 ("the 2003 Act"), whereby the Tribunal is required to identify whether an appeal under section 192 of the 2003 Act raises any "specified price control matters" as defined in that Act. If it does, then those matters are to be referred by the Tribunal to the Competition Commission for its determination.

Matters raised by the appeal which are not price control matters would be decided by the Tribunal. Once the Competition Commission has notified the Tribunal of its determination of the price control matters referred to it, the Tribunal must decide them in accordance with the determination of the Competition Commission, unless it decides, applying the principles applicable on an application for judicial review, that the Competition Commission's determination should be set aside: section 193(7) of the 2003 Act. In this approach, the Tribunal would be concerned only to see that everything relevant and nothing irrelevant has been considered, and that a rational mind had been brought to bear by the Authority in reaching the decision. This approach, said Dŵr Cymru, would secure the various objectives of rule 19 of the Tribunal Rules, namely justice, economy and expedition.

67. The second approach, favoured by Albion, recognises that the reference to an appeal “on the merits” in paragraph 3(1) of Schedule 8 means that the Tribunal's function is not limited to the review of the Report according to the principles of judicial review. In consequence the Tribunal should decide for itself whether the First Access Price is excessive and, if so, whether it is unfair and thus an abuse of a dominant position. Albion submitted that the Tribunal was as well placed as the Authority to form a judgment on the competing considerations as to whether the First Access Price was unfair, within the meaning of section 18(2)(a) of the Act.
68. A third approach lies somewhere between the first two; here the Tribunal would treat the Report as evidence. Counsel for Dŵr Cymru submitted that this was not appropriate, for two reasons. Such an approach was not envisaged by the questions referred to the Authority by the Tribunal, he said. Further, if it had been contemplated, the Tribunal would have asked the parties to adduce further evidence and make submissions; there would have been no need for an additional investigation by the Authority. Instead, Dŵr Cymru submitted that the Tribunal expressly directed the Authority to weigh up the evidence and submissions of both parties. In addition, the third approach would cause difficulties in securing the expeditious and efficient conclusion of the proceedings.

*The Tribunal's analysis*

69. In the Tribunal's judgment, Dŵr Cymru's position would restrict the Tribunal's role to a limited form of judicial supervision which is inconsistent with the merits jurisdiction prescribed under the Act. We reject so restrictive an approach. The Tribunal's powers in deciding this appeal are set out in paragraph 3(1) of Schedule 8 to the Act. That provision requires the Tribunal to decide the case "on the merits" by reference to the grounds set out in the notice of appeal.
70. The Tribunal has jurisdiction under paragraph 3(2)(e) of Schedule 8 to the Act to reach its own decision in respect of a matter forming part of the decision under appeal. The Tribunal has its own procedures and must act fairly when reaching a decision under that provision (see *Dŵr Cymru Cyfyngedig v Albion Water Ltd*, paragraph [56] above, paragraph [127]). Respect for the rights of the defence in proceedings before the Tribunal requires that the undertakings concerned be afforded the opportunity during the appeal to make known its views on the relevance of the facts, arguments and circumstances relied on by each party. It is for the party alleging an infringement to prove it and not for the dominant undertaking to demonstrate its absence. It is then for the dominant undertaking to raise any plea of objective justification and to support it with arguments and evidence. It then falls to the Tribunal, if it proposes to make a finding of an abuse of a dominant position under paragraph 3(2)(e), to give its reasons accordingly.
71. Where the Tribunal requires further information from the respondent authority, the Tribunal may refer back all or part of the case under rule 19(2)(j) of the Tribunal Rules. It is common ground between the parties that the Authority's further findings in this case were not an "appealable decision" within the meaning of sections 46 and 47 of the Act. The result of a referral should be a reasoned report which gives the parties and the Tribunal sufficient detail to enable them to understand why the conclusions have been reached, and for the Tribunal to examine the adequacy of the reasons supporting those conclusions and their correctness in law. The Tribunal is entitled to draw such inferences as are proper as to the validity of the findings. We may take into account the fact that evidence and explanations advanced before the Tribunal had not been advanced as part of the further investigation.

72. We are conscious, however, that in determining the lawfulness of an access price, there may be a number of different approaches which a regulator, exercising its concurrent powers with the OFT, could reasonably adopt in arriving at its decision. There may well be no single “right price” (see the further judgment, paragraph [251]). To that extent, the Tribunal will, whilst still carrying out an assessment of the merits of the case, give due weight to a finding which is arrived at by an appropriate and reliable methodology, even if a dissatisfied party could suggest other ways of approaching the issue which would also have been reasonable and which might have resulted in a resolution more favourable to its case.

## **IX. THE EVIDENCE RELATING TO COSTS**

73. This section examines the costs which were reasonably attributable to the partial treatment and transportation of water by Dŵr Cymru, generally and through the Ashgrove system in particular. There are a number of stages involved in the supply of non-potable water to customers which we summarise as follows: the first stage is the abstraction of water from a source, such as the River Dee in this case. The next stage is typically the partial treatment of the water, which here takes place at the Ashgrove water treatment plant. The third stage is the transportation of non-potable water from the treatment plant to customers’ premises through “non-potable distribution mains” (see paragraphs [450] *et seq.* of the main judgment). Finally, customers are then charged for the services that they receive.

74. The common carriage arrangement proposed by Albion, and the First Access Price at issue in this case, are solely concerned with the second and third stages. Following the general approach described in paragraph [63] above, we deal with the salient aspects relating to the key issues of the partial treatment and transportation of non-potable water, in the following order:

- (a) Methodology;
- (b) Cost of capital;
- (c) Cost of sludge disposal;
- (d) Cost of distribution pumping; and
- (e) Cost of the back-up supply.

## A. METHODOLOGY

### *Background*

75. For the reasons set out in the main judgment, the Tribunal had no verified figures to enable the actual costs of common carriage through the Ashgrove system in 2000/01 to be determined. In its earlier judgments the Tribunal made it clear it was seeking evidence in order to ascertain, on an AAC or other basis, the costs of transportation and partial treatment of water, in their component elements, even if approximately. The concern of the Tribunal was set out as follows in paragraph [607] of the main judgment:

“... We are concerned with a specific non-potable system in Wales. What is really in issue in that context is the failure of either Dŵr Cymru or the Authority to “disaggregate” the figure of 16p/m<sup>3</sup> into its component parts, so as to enable the Tribunal to ascertain whether or not costs had been properly attributed to non-potable users. *The Tribunal’s attempt to acquire a better understanding of the “actual” costs of the Ashgrove system was directed to establishing a more “disaggregated” picture of the costs of non-potable distribution. What is important, in our view, is that the heads of cost should be properly identified and quantified.* Whether the figures used are “local” or “average” is less significant.” (emphasis added)

(See also paragraphs [248]-[249] of the further judgment.)

76. The Tribunal further stated in paragraph [627] of the main judgment:

“In our judgment it follows from *United Brands*, and from the approach of the Commission in the Telecommunications Notice, that in ascertaining the “actual costs of supply” for the purposes of the Chapter II prohibition one should, so far as possible, seek to establish what the elements of costs are, and to disentangle the costs of the line of business under enquiry from the costs attributable to other businesses carried on by the allegedly dominant company.”

### *The Authority’s approach*

77. At the hearing in February 2008, counsel for the Authority confirmed that it had effectively “started from scratch” in undertaking its further work. The three methodologies now adopted were more locally cost based, or ‘granulated’, than the AAC methodology which Dŵr Cymru had originally used to justify the First Access Price. The Authority did not regard it appropriate to consider other methodologies. Therefore it did not recalculate an AAC based price. The Authority also stated that its preferred methodology was AAC+ which it said was the closest to that used in a regulatory context at the relevant time, i.e. 2000/01. The Authority then used LRIC and

LAC as cross-checks on the AAC+ methodology (Report, paragraph 6.3). The three methodologies are described in more detail in paragraphs [43] to [48] above.

*Albion's submissions*

78. Albion proposed four issues of principle in relation to the calculation of costs, as follows: (1) the costs in question should be “reasonably attributable” either to (a) “transportation” or (b) “partial treatment” of water by Dŵr Cymru; (2) the approach to be adopted to the identification and quantification of such costs should be consistent with the regulatory practice of the Authority; (3) the primary approach to the assessment of costs should be the “general” or “regional average” approach, (although Albion indicated that, in its view, the LAC, properly applied, could be the fairest approach to estimating cost); and (4) the more “granular” approach to the allocation of costs on a “regional average” basis, adopted by the Authority in its preferred AAC+ methodology, was likely to produce a more genuinely local/topical result than the AAC approach used in the Decision.
79. Albion did not object to the AAC+ methodology in principle, but was concerned about the way in which it had been applied by the Authority in practice. Albion submitted that the AAC+ methodology did not reflect: (a) contemporary regulatory practice; (b) the contemporary evidence concerning the calculation of the First Access Price; or (c) the Tribunal’s decisions in its earlier judgments in these proceedings. By seeking a greater degree of granularity of the costs associated with common carriage, Albion argued that the associated method of costs allocation in AAC+ ran the risk of errors and double counting. Accordingly, the results of the AAC+ methodology must be viewed with caution.
80. At the hearing, counsel for Albion indicated that it had always favoured the LAC methodology “as the fairest approach”, even though its third costs principle suggested that costs should primarily be assessed on a regional average basis (see paragraph [78] above). As with the other methodologies, Albion maintained that the reliability of the LAC results depended upon a realistic approach to valuations and consistency with its first two costs principles. Albion submitted that the results of the LAC methodology were flawed because, in particular, the MEAVs used were substantially inflated; the

cost of capital was unjustifiably disaggregated and a number of individual items, such as sludge management, were wrongly included in the Authority's calculations.

81. Albion further claimed that the LRIC methodology neither reflected regulatory best practice nor constituted a realistic approach to the assessment of incremental costs in this case.

*Dŵr Cymru's submissions*

82. Dŵr Cymru submitted that the results for all three methodologies were either incomplete and/or biased downwards. It claimed that the Authority had either omitted cost components, particularly connection costs (0.2p/m<sup>3</sup>), customer facing costs (1.5p/m<sup>3</sup>), and a full allowance for common costs, or understated those costs that had been included in all three methodologies.
83. Dŵr Cymru was content in principle with the Authority's use of an AAC+ methodology as an additional assessment of a lower bound for pricing in the context of excessive pricing. However, it asserted that the Authority had modified the pure AAC approach in a way that led to a systematic under-statement of costs. This was because the Authority made allowances by means of various weighting factors in relation to certain sub-functions, such as distribution pumping, to denote the fact that it may, or may not, apply to the specific situation of Shotton Paper and/or non-potable customers in general.
84. Dŵr Cymru submitted that the LRIC methodology should be used to assess the "lower bound" costs (since it did not include all relevant costs, notably the back-up supply) and therefore established a "floor" above which actual prices should be set. It argued that LRIC is an appropriate methodology to use to ensure prices are not predatory, and it is also a useful cross-check in ensuring that methodologies that are used for determining whether prices are excessive result in a cost calculation that exceeds LRIC.
85. Dŵr Cymru submitted that the LAC is a hybrid measure which is a flawed substitute for a proper assessment of the compatibility of the quoted First Access Price with the Chapter II prohibition. Moreover, Dŵr Cymru submitted that, in any event, the LAC results were incomplete due to the omission of connection costs and customer facing



costs and the under-estimation of the cost of sludge management and back-up supply. According to Dŵr Cymru, the Authority used a measure of capital value that reflected an 88% subsidy, as a consequence of which the results cannot be used for the purposes of a test for excessive pricing.

86. Dŵr Cymru argued that a stand-alone cost calculation, taking account of the value of the assets in question, subject to an appropriate market rate of return, was the appropriate benchmark for an excessive pricing test. According to Dŵr Cymru, a stand-alone cost calculation using the Authority's LAC methodology and based on unsubsidised asset values and the market rate of return would produce a figure of 40p/m<sup>3</sup> (compared to the result of 18.5p/m<sup>3</sup> in the Report or, as subsequently modified by the Authority, 19.2p/m<sup>3</sup>), confirming that the First Access Price was not excessive in relation to the costs reasonably attributable to the services in question.

*The Authority's response*

87. Apart from the adjustments it made in the light of the points of dispute raised by Albion and Dŵr Cymru, the Authority contended that the parties' various points of dispute in relation to its chosen methodologies should be rejected for the reasons set out in the Report and its responses in the 'Scott Schedule'.

*The Tribunal's analysis*

88. Despite the various cases in this area, no consensus has emerged as to what, if any, is the most appropriate method of measuring cost in excessive pricing cases. The ECJ has stated that the "costs actually incurred" must be ascertained (*United Brands*, paragraph [252]), but there is no rule of law as to how that is to be done: it is a matter of fact, accounting technique and economic assessment. However, Community jurisprudence only permits the inclusion of efficiently incurred costs (see *Case 395/87 Ministère Public v Tournier* [1989] ECR 2521, [1991] 4 CMLR 248, at paragraph [42]).
89. Paragraph [251] of the ECJ's judgment in *United Brands* refers to the "cost of production", without further definition. The Tribunal notes that the concept of costs in this context is not unambiguous: there are various possible costs, methods and models for cost calculation. In our view, it would be inappropriate in the present case to proceed on the basis of a simple comparison between the "cost of production" and an

access price in the relatively capital intensive water industry. Common carriage presupposes the existence of the assets (pipes, treatment works) over or through which access is sought. The calculation of an access price is intended reasonably to remunerate the owner for the use of the existing assets employed in serving a customer. It follows that the relevant components of costs that make up an access price should ordinarily comprise not only direct operating costs, but also the costs of maintaining the capital assets and a return on capital.

90. The parties have criticised the methodologies used, for various reasons. The Authority explained why it chose the three methodologies in section 6 of the Report. Both Albion and Dŵr Cymru made the point that none of the three methodologies used in the Report is the same as the AAC methodology originally used by Dŵr Cymru to calculate the First Access Price. While the judgment in *United Brands* focused on the costs *actually* incurred in providing the service, Albion and Dŵr Cymru have not yet entered into a common carriage arrangement. The arrangement remains a proposal, but it is still subject to the prohibitions contained in the Act. A further challenge to the Authority in this case was the need, at various times between 2004 and 2007, to determine the level of costs as they would have been in 2000/01, taking into account possibly different techniques and rates of inflation over the first part of the decade.
91. Part of Dŵr Cymru's case is that the Authority should have carried out a standalone cost calculation of the Ashgrove system. The Tribunal had already found, in the main judgment, that such an approach has little relevance to the determination of the issues in this case (see paragraphs [573] *et seq.*). As stated in paragraph [72] above, even if Dŵr Cymru were to show that the method which it advocates is appropriate in some respects, this would be insufficient to undermine the legitimacy of the methodologies actually used by the Authority in the Report. Accordingly, we reject Dŵr Cymru's contention that the Authority should have carried out a standalone cost calculation or that any resultant measure of cost should be the upper bound on any common carriage price.
92. It is clear from paragraphs [280]-[281] of the further judgment that the further investigation of the costs was, in the first instance, a matter for the Authority, while taking appropriate account of the Tribunal's analysis in its main and further judgments,

and the parties' observations. That being so, once the Authority had chosen the three methodologies, there was no need for it to address various alternatives proposed by the parties. The Tribunal has not found it necessary to address any further alternative methodologies.

93. Because there may be times when a competition authority or court needs the flexibility to examine more than one measure of cost in order to evaluate an allegedly excessive price, we do not prescribe a cost measure that would apply in all cases. In our view the use of more than one credible methodology, even if only as a cross-check, helps to minimise the risk of false positives and to assure confidence in the results obtained.
94. For its further work, the Authority's preferred methodology was AAC+ which it said was the closest to that used in a regulatory context in 2000/01. The Authority then used LRIC and LAC as cross-checks on this methodology. Before moving on to the detailed results, we offer some brief comments on the three methodologies. In approaching all three methodologies, the Authority was mindful of the need to use assumptions which would have been reasonable on the basis of the information available at the time at which the First Access Price was provided (Report, paragraph 1.12).

*AAC+ methodology*

95. In its interim judgment of 22 December 2005 ([2005] CAT 40, [2006] CompAR 269), the Tribunal sought a more "disaggregated" picture of the costs of non-potable distribution. The Tribunal noted in paragraph [464] of its main judgment that a striking feature of this case has been the lack of any detailed, or verifiable, break-down of the components of the cost of distribution at issue. The Tribunal subsequently decided that the question whether the First Access Price was "unfair" should be assessed on the basis of a fully informed calculation of costs (see paragraph [247] of the further judgment). The Tribunal therefore directed the Authority to re-investigate the costs reasonably attributable to the proposed common carriage arrangement, both in relation to non-potable users generally and the Ashgrove system in particular (see sub-paragraph (iii) of paragraph [360] of the further judgment).
96. As already noted, the Authority used the AAC+ methodology to calculate the relevant regional average cost of providing a service of the kind that Albion required for supply

to Shotton Paper in 2000/01. In its Response of 18 December 2007, the Authority submitted that the Tribunal's earlier judgments had caused it to carry out a more granular, or disaggregated approach to the allocation of costs on a regional average basis than in Dŵr Cymru's original calculations. The purpose of the AAC+ methodology appears to have been two-fold: first, to identify in more detail the individual cost components associated with common carriage and secondly, to provide a more locally cost-based approach than the AAC methodology used by Dŵr Cymru to calculate the First Access Price and used in the Authority's Decision (see Report, paragraph 6.9).

97. To the extent that the AAC+ methodology now enables the parties and the Tribunal to identify the individual cost components of supplies to non-potable users generally (Report, paragraph 7.5), it is an improvement on the various methodologies previously put forward during this appeal.
98. At the case management conference held on 23 October 2007, the Tribunal enquired: where in the Report the Authority had presented the costs reasonably attributable to the service of transportation and partial treatment of water by Dŵr Cymru *generally*. Paragraph 26 of the Authority's response of 18 December 2007 stated that the AAC+ methodology used the regional average costs for non-potable customers generally, but in order to calculate the costs reasonably attributable to the same service through the Ashgrove system in particular, the estimated regional average costs of the back-up supply were also included. However, this explanation was contradicted by paragraph 8(iv) of the Authority's skeleton argument of 8 February 2008 which indicated that the back-up supply should not be excluded from the calculation of costs generally "since that seeks to establish the costs reasonably attributable on a general basis *for the services required by Albion*" (emphasis in the original). We deal in paragraphs [157] to [188] below with the relevance of the back-up supply in this case.
99. The Tribunal has sought, so far as possible, to verify whether the regional average costs have been allocated to non-potable users generally on a justifiable basis.

### *LAC methodology*

100. The LAC methodology estimated individual local costs (capital values, capital maintenance and operating costs) for each functional activity and added a contribution for common costs, the costs of the back-up supply and the cost of common carriage services (Report, paragraph 9.5). Whereas Albion accepted the LAC methodology in principle, Dŵr Cymru argued that it has “no real value as a metric for assessing excessive pricing” in this case (see paragraph 13.4 of Dŵr Cymru’s observations on the Report dated 20 November 2007).
  
101. In our judgment, the Authority properly used the LAC methodology as a cross-check on the results of the AAC+ methodology. We accept that a calculation of the actual costs attributable to the Ashgrove system must be reliable and verifiable. In estimating the ‘local’ costs of supply, we bear in mind that the LAC methodology relied on accounting information and assumptions that, to a large extent, reflected company-wide average costs (Report, paragraph 6.37). These proceedings have clearly highlighted the paucity of information on individual, or “bottom up”, costs. Whilst this suggests that the results of the LAC methodology should be considered with a degree of caution, we do not consider it means that the LAC methodology was inappropriate or that its results should be disregarded.

### *LRIC methodology*

102. Both Albion and Dŵr Cymru took issue with the LRIC methodology. We note, in particular, that Albion was adamant there was no justification for the 20% increment in capacity on which the Authority had based its calculations. Dŵr Cymru submitted that the LRIC methodology was appropriate to ensure prices are not predatory, and that non-predatory prices exceed the level indicated by LRIC. According to Dŵr Cymru, LRIC is a useful cross-check in ensuring that methodologies that are used for determining whether a price is excessive result in a cost calculation that exceeds rather than falls below LRIC. We have considered the arguments concerning the LRIC approach and its potential results.
  
103. In the Tribunal’s judgment, there is no single “correct” or completely straightforward way in which to calculate costs in the water industry. There will always be a degree of

judgment involved in choosing which cost methodologies to apply when assessing the lawfulness of an access price. The Authority used three methodologies: AAC+ as the main methodology and LRIC and LAC as cross-checks (Report, paragraph 6.3). In view of our conclusion on the AAC+ methodology, as cross-checked by the LAC methodology, we do not find it necessary, in the circumstances of this case, to employ a further cross-check in the form of LRIC, especially since there appears to be a significant question mark over the use of that methodology in this case.

104. We note that the Authority did not carry out a calculation of the incremental costs of supply to non-potable users generally (see the Authority's response on page 102 of the 'Scott Schedule'). Moreover, the Authority has not argued that the LRIC methodology is a "cross-check of the costs actually incurred by Dŵr Cymru in providing its treatment and distribution service to Albion" (see the Authority's response on page 104 of the 'Scott Schedule').

105. As to Dŵr Cymru's argument that LRIC was an appropriate methodology to check that the First Access Price was not predatory, we do not consider that this is relevant to the questions posed by the Tribunal in paragraph [38] above. How the Authority or the Tribunal might use LRIC in a predatory pricing case is not at issue here (see paragraph [19] of the Authority's skeleton argument of 8 February 2008). What the Tribunal is considering in this case is whether a common carriage charge for the use of the Ashgrove system is excessive and unfair within the meaning of the Chapter II prohibition.

106. For that further reason, and on the particular facts of the present case, we do not consider that the LRIC approach set out in the Report is appropriate, or needed, to examine whether the First Access Price was excessive for the purposes of the Chapter II prohibition.

*The Tribunal's conclusion*

107. We think it is valuable that, in the circumstances of this case, the Authority provided more than one methodology to assist the Tribunal in assessing whether or not the access price is excessive for the purposes of the Chapter II prohibition. It is reasonable in the circumstances to use AAC+ as the main methodology to estimate the costs reasonably

attributable to the service of the transportation and partial treatment of water by Dŵr Cymru in relation to non-potable users generally. We also recognise the role of the LAC methodology as a means of verifying the AAC+ results and ascertaining the estimated costs of the Ashgrove system.

## B. COST OF CAPITAL

### *Introduction*

108. One of the distinguishing features of the water industry in England and Wales is the use of long-lived capital assets in the provision of water and sewerage services. It follows that water companies should be able, within reasonable limits, to meet their direct operating costs, recover their infrastructure costs, fund their investment programmes and recover a contribution to common overheads. Capital maintenance costs were included in the Authority's AAC+ and LAC methodologies in the Report. For example, tables 9 and 10 in the Report contain the estimated capital maintenance costs under the AAC+ methodology, comprising infrastructure renewals costs and current cost depreciation. In the case of the Ashgrove system, however, the Tribunal has already noted that Dŵr Cymru has enjoyed a substantial revenue stream of apparently over £2 million per annum for the last 20 years, from a pipeline that is 50 years old and has apparently required minimal maintenance and capital investment (see paragraph [591] of the main judgment).
109. The estimated capital cost of the "Ashgrove mains"<sup>5</sup> is influenced by various factors, including the diameter of the pipe, its length and the pipe (laying) depth. Taking these factors into account, the Authority assessed the MEAV of the Dŵr Cymru assets relevant to this case. The MEAV is an estimate of the present day cost of replacing the existing asset with a new asset of the same service capability. If, for example, an existing iron pipe could be replaced more economically by a plastic pipe of the same functionality, the MEAV would be based on the unit cost of laying a plastic pipe in that location. It does not, however, make allowance for technical improvements that may help to achieve efficiency gains. As part of its further investigation, the Authority asked Mott MacDonald, a firm of engineering consultants, to estimate the gross MEAV of the Ashgrove system. Mott MacDonald estimated that the gross MEAV of the main

---

<sup>5</sup> i.e. the raw water aqueduct from Heronbridge to the Ashgrove water treatment works, the sludge main and the non-potable bulk distribution main from the treatment works to the Shotton Paper site.

was £10.4 million. The Authority then used Mott MacDonald's estimate to inform its own estimate of the MEAV of the Ashgrove system in the LAC methodology (Report, paragraphs 9.41 to 9.42).

110. For each asset, the Authority adjusted the gross MEAV estimate to provide an infrastructure-specific "Regulatory Capital Value" ("RCV"), and then applied an estimate of the cost of capital for the Ashgrove system within Dŵr Cymru. The resulting gross MEAV estimates were then adjusted by a measure of the estimated cost of capital and ultimately converted to a unit capital cost for the services of partial treatment and transportation.
111. The cost of capital is the term used to describe the minimum return that investors (shareholders and lenders) require to be compensated for putting their money into a company and bearing the associated risks. Paragraphs 6.42 to 6.68 of the Report explain how the Authority approached the cost of capital in all three methodologies.
112. In summary, the Authority used a regulated cost of capital, albeit adapted to the circumstances of this case. It took as its starting point the "Final Determinations: Future water and sewerage charges 2000-05" dated 25 November 1999, a document in which the Director had analysed the cost of capital for water companies in some depth. In reaching those determinations, a real, post-tax cost of capital of 4.75% was used for all water and sewerage companies. This is equivalent to a cost of capital of 6.8% on a real, pre-tax basis (Report, paragraph 6.44). The Authority used this cost of capital in the AAC+, LRIC and LAC methodologies in its draft assessment.
113. The Authority subsequently considered that the appropriate cost of capital used to determine whether an access price is excessive can be different from the cost of capital used in a regulatory context (Report, paragraph 6.67). The Authority decided that calculating a disaggregated cost of capital in 2000/01 for the Ashgrove system would be internally consistent with the more locally-based nature of the Authority's chosen cost methodologies. However, Dŵr Cymru does not disaggregate its cost of capital. For that reason, with the assistance of an external economics consultancy, Europe Economics, the Authority estimated Dŵr Cymru's disaggregated pre-tax cost of capital for serving industrial, non-potable customers in 2000-01. A summary of the Europe



Economics report of 4 June 2007 is contained in paragraphs 6.52 to 6.54 of the Report. Europe Economics estimated that the cost of capital for water supply to industrial, non-potable customers would be 3.0 percentage points higher than for water supply as a whole.

114. In the Report the Authority used an estimate of the disaggregated cost of capital of 8.0% in the AAC+ methodology and 11.1% in the LAC and LRIC methodologies (see the Report, at paragraphs 1.13, 6.55-6.56 and 6.66). The Authority justified these higher values on the grounds that they addressed the increased revenue risk involved in supplying large industrial customers on discrete non-potable systems (see Report, paragraph 6.53).

*Albion's submissions*

115. Albion submitted that the Authority's decision to use a disaggregated cost of capital was wrong in principle. It was inconsistent with its own tariff setting rules; and discriminatory against Albion to treat Dŵr Cymru differently from other regulated water companies in respect of the regulated cost of capital. Albion argued that the approach of the Authority to cost of capital was contrary to the approach of the Tribunal at paragraphs [584]-[598] of the main judgment. It further submitted that the use of Dŵr Cymru's disaggregated cost of capital for serving industrial, non-potable customers resulted in inflated, and thus flawed, cost calculations. In the absence of specific figures based on the regulated rate of return at the relevant time, however, Albion was not in a position to quantify the extent of the cost inflation. Finally, Albion complained that the Authority had not presented the cost of capital figures for sensitivity checks on the three methodologies.

*Dŵr Cymru's submissions*

116. Dŵr Cymru submitted that the cost of capital used by the Authority was too low. In all the methodologies the Authority should have used a higher cost of capital of about 19%. The Authority's approach, it said, meant Albion benefited from an unjust assumption in the calculation of the First Access Price. That assumption related to the cost of capital which treated a relatively high risk commercial non-potable supply on a discrete system with a high risk of asset stranding (supply to Shotton Paper) as if it

were a low risk potable domestic supply that attracted a low cost of capital. This had the effect of creating a government subsidy as a consequence of the applicable regulatory regime.

*The Authority's response*

117. The Authority contended that the arguments in relation to cost of capital should be dismissed. The Authority also rejected the contention that its approach to cost of capital was wrong in principle or unlawful for the reasons set out in paragraphs 6.42 to 6.68 of the Report.

*The Tribunal's analysis*

118. As a preliminary point, we note that in any investigation of alleged abusive pricing, one of the first tasks for a competition authority is to obtain detailed and reliable evidence of the costs involved. This applies no less to capital cost estimates as to direct costs. The extent to which the value of capital assets should be included in any cost calculation, and, if so, on what basis of valuation, may be particularly sensitive where the assets in question are “sunk”, in the sense of having no alternative use value; and where they may be fully depreciated. As a privatised and regulated sector, the water industry raises additional complexities in terms of the valuation of assets acquired at a discount on privatisation and the cost of capital to be built into any cost calculation.
119. In the present case, we note that the LAC methodology calculates capital costs by applying the cost of capital to each asset value on an MAC basis. The accuracy of the MEAV estimates is important because it serves as the basis for the MAC capital base used in the LAC methodology. The Tribunal observes that there appears to have to been some force in Albion's challenge to the pipeline depth assumption of 4-5 metres made by Mott MacDonald in order to estimate the MEAV of the treated water pipeline. As noted above, the depth of the trench required for laying a pipe is one of the key cost drivers in respect of non-potable water distribution systems. We note that the Authority estimated Mott MacDonald's gross MEAV estimate for the treated water main would be reduced by approximately £1.7 million if the pipe depth assumption was reduced from 4-5 metres to around 2-2½ metres. In the event, the Authority explained in paragraph 13 of its skeleton argument of 8 February 2008 that the pipeline depth

assumption which Mott MacDonald had, in fact, used was 3-4 metres, not 4-5 metres as set out in Mott MacDonald's report of 6 June 2007. The Tribunal is not in a position to determine the accuracy of the gross MEAV estimates since the Authority did not provide the parties or the Tribunal with its detailed calculations. In the event, in the light of its overall conclusions, the Tribunal is satisfied that there is no need to investigate further the MEAV estimates used in the Report.

120. Albion and Dŵr Cymru both challenged the correctness of the approach taken by the Authority in section 6B(1) of the Report, and in particular whether it was appropriate to disaggregate the costs of capital for supplying large non-potable customers.

121. Various approaches could be adopted to establish an appropriate cost of capital. The cost of capital in a regulated market will not be the same as a private sector company's cost of capital in a competitive market. The former will generally be lower to reflect the reduced risks and higher investment grades arising from the regulatory framework.

122. In the main judgment the Tribunal stated that, if access prices are arrived at on an average accounting cost basis, it should be possible to verify the costs in question or at least identify the components of costs on an estimated basis (paragraph [470]). That being so, the Authority was correct in this respect in not looking at the cost of capital of a stand-alone company serving Shotton Paper but rather at Dŵr Cymru's cost of capital for serving industrial, non-potable customers. The higher rate of return of 17½% advocated by Dŵr Cymru was its estimate of what would be required by a hypothetical private investor to build an entirely new Ashgrove system from scratch. That is not an appropriate basis for charging for the use of the Ashgrove system: common carriage is predicated on the use of the existing assets. In our view, the initial question of excessive pricing should be judged by reference to a realistic estimate of costs, including a cost of capital based on existing regulation, which reflects the position of Dŵr Cymru as a dominant water company benefiting from the use of major fixed assets inherited from the UK government at a very substantially discounted value.

123. Dŵr Cymru has sought to persuade us that the Authority's estimate of the cost of capital was too low. It made various criticisms (set out on pages 119 to 130 of the 'Scott Schedule'), in particular that: (a) the Authority used the wrong figures for the

cost of capital that it had allowed at the Final Determinations in 1999; (b) the volatility analysis contained in Europe Economics' report wrongly included volumes for other water undertakers, and omitted data for the volumes supplied to Shotton Paper; and (c) the Authority did not draw the proper distinction between the treatment of systematic and non-systematic risks. As explained below, the Tribunal agrees with the Authority's response to Dŵr Cymru's points of dispute.

124. The first issue between Dŵr Cymru and the Authority related to the value used for the cost of capital. We note that the Authority used Dŵr Cymru's actual, real, pre-tax rate of return of 3.7% on its water supply business in 2000/01, as the starting point for its analysis. Dŵr Cymru has provided no convincing explanation as to why the 3.7% figure was "subsidised" or distorted. We have borne in mind the point made by the Authority that using Dŵr Cymru's actual return as the starting point in the AAC+ methodology (rather than its regulated cost of capital) could allow an incumbent water company to recover more than the regulated cost of capital from a new entrant seeking to enter into a common carriage arrangement. This could occur if Dŵr Cymru's actual return had exceeded the regulated cost of capital. However this was not the case at the material time, i.e. in 2000/01.
125. As regards Dŵr Cymru's argument that Europe Economics' risk analysis excluded Shotton Paper's volumes for part of the time period, we accept the Authority's response that including Shotton Paper's volumes in the relevant data-set would only have had a minor effect on the volatility measure. We can see the force of Dŵr Cymru's point that, in principle, only volumes delivered by Dŵr Cymru should be used in any volatility analysis, in the absence of the underlying data and detailed calculations. However, we note the Authority's reluctance to depart from Europe Economics' analysis in order to minimise the risk that the data could be distorted by company-specific shocks not reflecting the longer-term risk of supplying non-potable water.
126. Dŵr Cymru also challenged the failure by Europe Economics, and subsequently by the Authority, to take into account asymmetric risk to which discrete non-potable systems are allegedly subject. Dŵr Cymru argued that the risk of the Ashgrove system becoming a stranded asset was an asymmetrical non-systematic (i.e. diversifiable) risk

which needed to be included in addition to the adjustment for the increased risk of industrial non-potable supplies.

127. We are not satisfied that, in the circumstances of the present case, it would be right to adjust the Authority's cost calculations to include the risk of asset stranding in addition to the adjustment for the increased risk in making industrial non-potable supplies. The Tribunal notes, first, that adjusting the cost calculations in the way urged by Dŵr Cymru might entail double-counting of the risk of asset stranding and the increased risk of serving industrial, non-potable customers (see Report, paragraph 6.54); secondly, that the Authority ultimately decided to include stranded non-potable asset costs in the capital base for the AAC+ and LAC methodologies (see the Authority's response on pages 22-23 and 122-123 of the 'Scott Schedule'). The Authority acknowledged that the omission of stranded asset costs in the AAC+ and LAC methodologies was an error in the Report. The inclusion of such costs, however, would reflect regulatory practice that efficiently incurred investments continue to be remunerated at the appropriate cost of capital. The inclusion of such costs also suggests that there was no need for a separate uplift on the cost of capital to reflect compensation for the risk of asset stranding.

128. Albion also objected to the Authority's use of a disaggregated cost of capital. In paragraph 6.45 of the Report the Authority stated that it used a disaggregated cost of capital in order to identify a local, Ashgrove-specific, set of costs. The Authority explained that, in its view, it was internally consistent with the various methodologies to use local costs, including a local cost of capital (Report, paragraph 6.50). Although it is not necessary for the Tribunal to decide the point, the Tribunal is not convinced that it was appropriate to adopt a different cost of capital in this case since there is no evidence that this was a local cost, directly incurred. If Dŵr Cymru were to be permitted to use a higher, disaggregated, cost of capital in arriving at the First Access Price, to reflect the supposedly higher revenue risk to a water company of serving Shotton Paper, it would inevitably be using a higher cost of capital than that used in the Final Determinations in 1999. We note that this would have required both a reduction in the cost of capital on the rest of Dŵr Cymru's regulated business and an adjustment of retail prices for household and other industrial customers as a result. However, the

Authority acknowledged that this was never a practical proposition in 2000/01, nor did it occur in practice.

129. The Tribunal also notes that paragraph 6.44 of the Report indicates that a cost of capital of around 6.8% on the RCV of Dŵr Cymru is equivalent to a cost of capital of around 1% on a gross MEAV basis. This figure is not only in line with the average return on MEA values for the water industry, but also broadly accords with the assumption made by the Tribunal in paragraph [586] of the main judgment that Dŵr Cymru's regulated water business earns the equivalent of around 1% of the MEA value of its assets. That being the case, it is not necessary for us to consider this issue further since it does not affect the Tribunal's overall assessment of the First Access Price. It is therefore reasonable, in the particular circumstances of this case, to address the questions posed in paragraph [252] of the judgment in *United Brands* on the basis that the Authority's approach to the cost of capital in the Report was appropriate.

130. We turn now to the parties' submissions in relation to certain specific costs components.

### C. COST OF SLUDGE DISPOSAL

#### *Introduction*

131. The parties and the Authority identified several services during the course of the further investigation which had not been fully included in the Authority's previous costs calculations produced to the Tribunal (see paragraphs [567] *et seq.* of the main judgment). One of these services related to the processing and disposal of sludge created by the partial treatment of raw water. According to the Authority's response to the parties' points of dispute in relation to paragraph 7.43 of the Report, both sludge processing and sludge disposal costs were reasonably attributable to the service of the partial treatment of water by Dŵr Cymru, generally and through the Ashgrove system in particular (pages 13-17, 24-26 and 172 of the 'Scott Schedule').

132. As already noted, the water intended for the Ashgrove system is abstracted from the River Dee by United Utilities at the Heronbridge pumping station. The water passes into the Dŵr Cymru supply area, from where it is pumped a short way to the Ashgrove water treatment plant. There, aluminium sulphate is added to the water, which then

passes through sedimentation tanks called clarifiers. The various solids and particulates in the water react with the aluminium sulphate and coagulate to form a “sludge blanket” within each clarifier. This blanket effectively acts as a filter. As the water passes through each sludge blanket, the solids and particulates are progressively filtered out into the sludge, which is periodically removed.

133. At the material time (i.e. when the First Access Price was quoted in March 2001), the water sludge was discharged directly into the River Dee (Report, paragraph 5.26). Following its further work, the Authority reported that, from 2002/03 to the present, the water sludge has been transported by a dedicated 1.7 kilometres sludge main and sewer to the Chester sewage treatment works. The sludge is then disposed of with the sewage sludge from the Chester works.
134. The Authority’s approach to the costs of disposing of the sludge created by partially treating the water supplied to Albion is described in general terms in paragraphs 5.26 to 5.27 of the Report. In the Authority’s view, the additional costs of sludge management were attributable to the treatment function of the Ashgrove system in 2001. In the Report, as explained further in paragraph [137] below, the Authority excluded sludge disposal costs from the AAC+ methodology, but included those costs in the LRIC and LAC methodologies.

*Albion’s submissions*

135. Albion claimed that the costs of sludge disposal should not have been included in the AAC+ and LAC methodologies. Albion pointed to the fact that sludge disposal costs were not included in the quoted First Access Price since that price was calculated using Dŵr Cymru’s regulatory accounts, which do not make any provision for that activity. Including sludge disposal in the calculation of the cost element in the First Access Price would mean that Dŵr Cymru recovered those costs twice over: once from its sewerage customers and once from its non-potable water customers. Any such costs should properly be charged to sewerage customers. Alternatively, Albion suggested that charging non-potable water customers, but not other water customers, for sludge disposal would constitute unlawful price discrimination.

*Dŵr Cymru's submissions*

136. Dŵr Cymru submitted that the results for the AAC+ methodology wrongly omitted the costs of the transfer, treatment, and disposal of sludge from the Ashgrove treatment works. Further it claimed that in the LAC methodology, the Authority had underestimated the total sludge load that is discharged from the Ashgrove treatment works.

*The Authority's response*

137. The Authority originally excluded sludge disposal costs from the AAC+ methodology, which used the water service regulatory accounts as the main input for the cost allocation exercise (Report, paragraph 7.44). However, the Authority subsequently accepted Dŵr Cymru's argument that the costs of transfer, treatment and transportation of sludge were incurred as part of the treatment function at Ashgrove and should have been included in the AAC+ methodology (see pages 24 to 25 of the 'Scott Schedule'). The Authority accepted that including these costs may have necessitated a small adjustment to retail tariffs in 2000/01.
138. The Authority maintained its view that both sludge processing and sludge disposal costs were "attributable" to "the partial treatment of water by Dŵr Cymru through the Ashgrove system in particular" under the LAC methodology.
139. The Authority denied that including sludge disposal costs under the AAC+ and LAC methodologies would be unduly discriminatory.

*The Tribunal's analysis*

140. In our judgment, the costs of sludge disposal were not reasonably attributable to the service of the partial treatment of water by Dŵr Cymru through the Ashgrove system. We note that the evidence already before the Tribunal indicated that the treatment costs should be in the range of 1.6p/m<sup>3</sup> to 3.2p/m<sup>3</sup> (see section IX of the main judgment). Moreover, we note that the costs of sludge disposal were included in the sewerage service regulatory accounts in 2000/01 (Report, paragraph 7.44). That being the case, it was inappropriate for the Authority subsequently to allocate sludge disposal costs to a common carriage access price when those costs already formed part of sewerage tariffs.



141. We are also of the view that it could be discriminatory for Dŵr Cymru to charge Albion for the costs of sludge disposal in calculating an access price when those costs are not allocated to other customers for charging purposes. As noted in paragraph [582] of the main judgment, a common carriage charge ought to be calculated in a manner that is consistent with the principles applicable to the charges made to customers generally.
142. In view of our conclusion that sludge disposal costs were not reasonably attributable to the supply to the Ashgrove system, it is not necessary for us to consider Dŵr Cymru's submission that the Authority had under-estimated the size of those costs.

#### D. COST OF DISTRIBUTION PUMPING

##### *Introduction*

143. The Tribunal concluded at paragraph [636] of the main judgment that the matter of the “distribution” cost of non-potable water, on an average accounting cost basis, had not been sufficiently investigated. Only 1p/m<sup>3</sup> of the 16p/m<sup>3</sup> estimated distribution costs included in the First Access Price was directly explained. The Tribunal held that the cost of non-potable water distribution was probably less than the cost of distribution of potable water and wished this to be explored further. Hence, the Tribunal subsequently directed the Authority further to investigate the calculation of Dŵr Cymru's transportation costs, both on the basis of an average for non-potable users generally and, as a cross-check, in relation to the Ashgrove system (see sub-paragraph (iii) of paragraph [360] of the further judgment).
144. The Authority's preferred AAC+ methodology “goes into a greater level of functional granularity” and separated the distribution element of the First Access Price into a number of different sub-functions, i.e. pumping (1.2p/m<sup>3</sup>), storage (1p/m<sup>3</sup>), mains (2.6p/m<sup>3</sup>), and customer interface (4.8p/m<sup>3</sup>) (Report, paragraphs 7.51, 7.54 and Table 16). The activity of pumping was then separated into two further sub-functions: “water resource pumping” and “water distribution pumping”.

145. All the non-potable systems<sup>6</sup> referred to in the present case begin with the abstraction of water from the environment. This may, as in the case of Ashgrove, entail pumping quantities of raw water directly from a river. The extent of water resource pumping (in terms of the size of the pumps) is said to be particularly extensive on the larger non-potable systems, including Ashgrove (see paragraph 7.3 of the Report). However, the Authority noted that Albion's common carriage proposal was effectively seeking to bypass Dŵr Cymru's water resource pumping assets by purchasing this particular pumping sub-function directly from United Utilities. The Authority therefore concluded that the cost of water resource pumping was not reasonably attributable to the service of the transportation of water by Dŵr Cymru, generally and through the Ashgrove system in particular (see, for example, paragraph 7.60 of the Report).
146. After the water is partially treated, it has to be delivered to customers. This is typically achieved by means of a further network of pipes and, in many systems, network pumping or booster stations, which enable fluctuations in the demands of non-potable customers to be managed without subjecting the water treatment works to unduly large variations in loads. Dŵr Cymru owns a total of 13 non-potable water distribution pumps, which operate on three systems (S4, S5 and S6), but no distribution pumping is required on the Ashgrove system (S10) because non-potable water flows as a result of the force exerted by gravity from the treatment works through the Ashgrove pipeline to Shotton Paper (see the main judgment, paragraph [72]).

*Albion's submissions*

147. Albion submitted that it should not have to pay for a service which it does not actually receive: the costs of distribution pumping were, and are, not reasonably attributable to the service of the transportation of water through the Ashgrove system.

*Dŵr Cymru's submissions*

148. Dŵr Cymru submitted that the Authority was wrong to exclude distribution pumping from the AAC+ calculation. The Authority recognised that, overall, the 10 non-potable systems make considerable use of pumping assets (Report, paragraph 7.60) and,

---

<sup>6</sup> For a short description of Dŵr Cymru's nine discrete non-potable supply systems, apart from Ashgrove, see paragraph [204] of the main judgment. A summary of Dŵr Cymru's non-potable assets is contained in Table 6 of the Report.

irrespective of the fact that there is no distribution pumping on the Ashgrove system, the Authority should have used a non-zero weight for distribution pumping for non-potable customers as a class.

*The Authority's response*

149. In the Report, the Authority noted that water resource pumping did not form part of the functions/services required by Albion as an integral or complementary part of the proposed common carriage arrangement. Under that arrangement, Albion would purchase the water resource and the associated pumping function directly from United Utilities. Because the Ashgrove system is a “gravity main” without any pumping after the water in question passes from United Utilities to Dŵr Cymru, in the AAC+ methodology, (by applying a 0% weight) the Authority excluded all pumping costs from its calculations (see paragraph 7.52 of the Report).
150. In response to one of Dŵr Cymru’s points of dispute in relation to the Report (see pages 17-18 of the ‘Scott Schedule’), the Authority subsequently accepted that non-potable water distribution pumping should be included as a reasonably attributable transportation cost under the common carriage arrangement proposed by Albion. The inclusion of distribution pumping costs added around 2.0p/m<sup>3</sup> to the result for the AAC+ methodology contained in the Report (19.3p/m<sup>3</sup>), without distinguishing between the costs of supplying non-potable users generally and the costs of the Ashgrove system.
151. The Authority pointed out that the disparity between the AAC+ and LAC derived costs for bulk distribution was explained by the inclusion of distribution pumping in AAC+ but not LAC. This disparity was said by the Authority to be an inevitable consequence of the regional average costs including the costs of functions which were not necessarily received by a particular non-potable system (Report, paragraphs 7.2 to 7.4).

*The Tribunal's analysis*

152. In the main judgment the Tribunal observed at paragraph [520] that:

“... what we are considering here is a common carriage charge for the use of the Ashgrove system. As Albion envisages it, the water in question would be supplied by United Utilities, and Albion would have to pay United Utilities for

the pumping facilities at Heronbridge: in that scenario, the pumping at source would be part of the acquisition cost of the water, not its subsequent distribution. In those circumstances, to include “pumping at source” as part of the “distribution charge” for common carriage would apparently be requiring Albion to pay twice over, once to United Utilities and again to Dŵr Cymru in the “distribution charge” (although the Ashgrove system is, in fact, a “gravity main” without any pumping after the water in question passes from United Utilities to Dŵr Cymru).”

153. The Authority agreed with the above observation, at least in so far as it related to the AAC calculation that produced the First Access Price, and the assessment of that calculation in the Decision (Report, paragraph 7.50). Under the proposed common carriage arrangements Albion would have purchased the limited pumping function it required directly from United Utilities (Report, paragraph 7.52). On this basis, the Authority applied a 0% weight and excluded *all* pumping costs (Report, paragraph 7.60).
154. It is clear that the costs of distribution pumping were reasonably attributable to the service of the transportation of water for supplies by Dŵr Cymru to non-potable users *generally*. It follows that the AAC+ methodology should include an appropriate proportion of the regional average costs associated with non-potable water distribution pumping. This should be charged to non-potable customers generally, including Albion.
155. This leaves the question whether the costs of distribution pumping were reasonably attributable to the service of the transportation of water for supplies by Dŵr Cymru through the Ashgrove system *in particular*. The Tribunal agrees with the submissions made by Albion (see Transcript of hearing, 14 February 2008, page 15, lines 16-25). The Ashgrove system operates by a “gravity main” and does not require distribution pumping as such (see paragraph [146] above). It follows logically that the costs of distribution pumping were not reasonably attributable to the service of the transportation of water through the Ashgrove system.
156. Further, we note that the ‘plus’ element of the AAC+ methodology is, in part, designed to be more responsive to the existence or *absence* of local, Ashgrove-specific costs (see paragraph [96] above). The Tribunal therefore finds that the costs of distribution pumping should be excluded from the AAC+ cost calculation insofar as it relates to the cost of supply through the Ashgrove system.

## E. COST OF THE BACK-UP SUPPLY

### *Introduction*

157. Under its inset appointment, Albion is the supplier to Shotton Paper of both potable and non-potable water. The Authority and Dŵr Cymru have both emphasised the importance of back-up supply in ensuring the security of supply to Shotton Paper. Back-up supply, as its name implies, refers to the costs attributable to providing a reserve supply of water to Shotton Paper in the event that the Ashgrove system breaks down. The water treatment works at Bretton supplies potable water, via a separate system to Albion, for onward supply to Shotton Paper. Paragraphs 6.83 to 6.94 of the Report provide a detailed description of how the back-up supply operates.
158. Under the Second Bulk Supply Agreement, signed on 10 March 1999, Dŵr Cymru was required to supply a reserved amount up to 18 megalitres per day (Ml/d) of non-potable water. In addition it would endeavour to provide an additional 4 Ml/d of non-potable water on request, and supply up to 8 Ml/d of potable water to make up any shortfall (either as a partial stand-by or as a top-up) in Albion's non-potable supply.
159. The lagoons owned by the neighbouring company, Corus, also enabled Dŵr Cymru to control the flows of water through the Ashgrove system in the event of any variation in Shotton Paper's demands for water. However, the Authority found that the lagoons did not offer a satisfactory alternative (Report, paragraph 5.48). Rather, in the event of a system failure, it would have been necessary for Shotton Paper to be supplied with a fall-back supply of (potable) water, which would have come from the Bretton works.

### *Albion's submissions*

160. Albion's primary submission was that the inclusion of the costs of a back-up supply in both the AAC+ and LAC methodologies was wrong in principle and inconsistent with the contemporaneous documents. The back-up supply did not form part of the relevant service of transportation or treatment, was not mentioned in the contemporaneous documentary record and was considered by Dŵr Cymru at the material time to be a separate issue from the First Access Price. Albion claimed that it was only after the Authority raised the question of the back-up supply during the further investigation that Dŵr Cymru sought to include it in arriving at the First Access Price.

161. Albion also took issue with the quantum of the back-up supply costs, submitting that they were already captured in potable tariffs and therefore fully accounted for. Thus any attempt by Dŵr Cymru to levy an additional charge for the back-up supply as part of the First Access Price would lead to significant over-recovery.

*Dŵr Cymru's submissions*

162. Dŵr Cymru submitted that the question whether it was correct to include the back-up supply in the assessment of relevant costs was necessarily hypothetical because, first, the First Access Price was a company average price and secondly, the common carriage arrangement was only a proposal. Dŵr Cymru accepted that the back-up supply was neither explicitly included, nor explicitly excluded from the First Access Price. However, Dŵr Cymru submitted that Albion would have required the back-up supply and, given that Dŵr Cymru would have provided that service, Albion should be expected to pay for it. Dŵr Cymru argued that there was no credible evidence showing that this service would have been negotiated separately from the common carriage agreement. That being the case, and in order to ensure full cost recovery, Dŵr Cymru further submitted that the costs of the back-up supply should have been included in the LRIC model.

*The Authority's response*

163. The Authority submitted that the cost of the back-up supply was included in order to calculate the costs reasonably attributable, on a general basis, to the services required by Albion, in addition to an Ashgrove-specific costs calculation. Back-up supply would have been a particular requirement for the common carriage services required by Albion. In that regard, the Authority referred to its reasoning in paragraphs 5.37 to 5.72 of the Report (which was adopted by Dŵr Cymru in its reply skeleton of 12 February 2008 in response to Albion (“reply skeleton”). However, on the LRIC methodology, the quantum of the back-up supply is not affected by the assumed step-change in capacity and thus does not appear as an incremental cost (Report, paragraph 8.118), and should therefore be excluded from the fixed back-up supply costs.

*The Tribunal's analysis*

164. The inclusion, and estimated cost, of the back-up supply was disputed between the parties during the further investigation (Report, paragraph 5.37) and before the Tribunal. In order to examine the relevance of the back-up supply, we first consider whether Albion would have required a back-up supply as part of the common carriage arrangements; and, if so, whether the costs of the back-up supply should have been included in assessing whether the First Access Price was excessive.
165. As a preliminary point, it should be noted that the significant costs associated with the back-up supply did not feature in the earlier stages of the proceedings before the Tribunal. The Authority claimed that, in the stand-alone cost calculations made by Dŵr Cymru and the Authority prior to the hearing in May 2006, the costs of the back-up supply should have been included (Report, paragraph 5.38).
166. In referring part of the Decision back to the Authority under rule 19(2)(j), the Tribunal expressly envisaged a short further investigation of the costs of partial treatment and distribution (see paragraph [247] of the further judgment). The Tribunal expected the Authority to identify costs relating to the transportation of non-potable water. According to the Authority there had been no previous need to investigate the costs of the back-up supply, since it was only assessing bulk distribution costs on a regional average basis. We are concerned that it has taken so long to identify the cost of the back-up supply which, we are now told, is highly material to the services required by Albion. Had the back-up supply been vital to the common carriage arrangements proposed by Albion, as the Authority and Dŵr Cymru now contend, we would have expected the cost of providing such a service to have emerged at a much earlier stage of these proceedings. All the Tribunal's judgments in this case have made it very clear that we wish to understand, so far as possible, the "local" costs attributable to the Ashgrove system as a cross-check on the regional average approach.
167. We have considered the parties' submissions on the question of the back-up supply and examined the documents contemporaneous with the negotiations preceding the quotation of the First Access Price, since it seems to us that a document prepared at the time is likely to be more credible than explanations given later.

168. We note that, in its response to Dŵr Cymru’s “Network Access Questionnaire – Preliminary Stage” dated 20 October 2000, Albion, in answering a question concerning its proposed contingency plans in the event of a failure of supply, referred to the extant back-up supply provided for in the Second Bulk Supply Agreement. The relevant provisions of that agreement were summarised in paragraph [158] above. Albion’s response clearly indicated that it would have required a back-up supply. It also revealed that, at the relevant time, Albion’s apparent intention was to continue with the back-up supply arrangements contained in the Second Bulk Supply Agreement (as opposed to requiring such a service as part of any common carriage arrangement).
169. It is true that a draft common carriage agreement between Dŵr Cymru and Albion dated 8 November 2000 added confusion to an already complex matter. It was drafted by Albion and initially provided for a back-up supply. However, the reference to this was removed by Dŵr Cymru’s lawyers. In other words, the redactions made on behalf of Dŵr Cymru were in line with Albion’s response to the network access questionnaire.
170. We note that Albion said it had explored alternative options for a back-up supply. However, the Tribunal is in no position to assess the probability of these being realised.
171. In our judgment, it is clear, and we do not understand Albion to dispute, that it would have needed a back-up supply (whether potable or not) in order to augment, as and when appropriate, the supply of non-potable water through the Ashgrove system. It does not necessarily follow that the back-up would have come from Dŵr Cymru or would automatically have formed part of the proposed common carriage. During the further investigation, Dŵr Cymru maintained that the future arrangements for providing, and charging for, the back-up supply at the time of the First Access Price were unknown.
172. In paragraph 26 of its Response dated 18 December 2007, the Authority stated that the costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru generally can be derived from deducting the cost of the back-up supply from the total costs calculated pursuant to the AAC+ methodology. The crucial question, therefore, is whether the Authority was correct to find that the back-up supply was reasonably attributable as a cost of the transportation of water by Dŵr Cymru



through the Ashgrove system in particular, as calculated under the AAC+ and LAC methodologies.

173. It is for Albion to show that the costs of a (potable) back-up supply were not reasonably attributable (on a general or Ashgrove-specific basis) to the services that it required. It can do so by showing that it was more likely than not that the back-up supply was either irrelevant to its common carriage requirements and/or that the cost of the back-up supply would, in all likelihood, have been charged for separately.
174. It is clear from the various responses it made during the Authority's further investigation that Albion did not consider that the provision of a back-up supply of (potable) water was part of the common carriage it was seeking to establish (Report, paragraph 5.50). Albion further claimed that it was clear to all concerned in 2001 that the back-up (potable) supply would have been negotiated as part of a separate revised bulk supply agreement and was not, therefore, part of the proposed common carriage arrangement for non-potable water.
175. Dŵr Cymru's position on the relevance of the back-up supply was equivocal. At one stage, Dŵr Cymru indicated that the inclusion of the costs of the back-up supply in the First Access Price "had not been clarified either way" (Report, paragraph 5.52). Dŵr Cymru referred to the fact that: (a) Albion would have required the back-up supply, and (b) there was some uncertainty as to what functions the "indicative" First Access Price might have covered. However, Dŵr Cymru also indicated that, had Albion agreed to pay the First Access Price, Dŵr Cymru would have provided the back-up (potable) supply as part of the common carriage arrangements (Report, paragraphs 5.54 *et seq.*). In our judgment, Dŵr Cymru's contention *now* that the back-up supply would have been provided had the parties actually entered into a common carriage arrangement is misconceived. The question is whether it is reasonable to assume that the costs of the back-up supply were included in the First Access Price in 2000/01. In our judgment, such an assumption is not justified.
176. We have found no sufficient evidential basis for the Authority's conclusion that the costs of the back-up supply were "reasonably attributable" to the services to be supplied, for several reasons.

177. First, the evidence leads us to conclude that the provision and costs of the back-up supply would have been included as part of a separate *potable* bulk supply agreement. In so far as Albion’s proposed common carriage arrangement sought to preserve as much of the *existing* arrangements as possible (as indicated in its response to Dŵr Cymru’s network access questionnaire), any back-up supply may reasonably be expected to have formed part of a bulk supply agreement. This suggests that Albion was first seeking to negotiate a common carriage agreement for the non-potable supply before addressing the terms of any bulk potable supply. Indeed, Dŵr Cymru’s terms and pricing of non-potable water transport and treatment services to Albion would naturally have informed the parties’ negotiations in relation to a bulk potable supply as a back-up for those services. The way in which Dŵr Cymru’s lawyers marked up the draft common carriage agreement – removing the reference to the back-up supply – supports the view that the back-up supply, if provided by Dŵr Cymru, would have been charged for separately.

178. Secondly, we note that there appears to have been no discussion in Dŵr Cymru’s internal documents which set out the approach it adopted in setting the First Access Price in early 2001. Those documents were provided by Dŵr Cymru pursuant to a formal notice dated 29 June 2001 issued by the Authority under section 26 of the Act. The Tribunal ordered disclosure of the unredacted Dŵr Cymru documents for the reasons given in its judgment of 17 January 2007 ([2007] CAT 3, [2008] CompAR 103). We refer in particular to a document “LCE/01/001” which was prepared by Mr. Dave Holton, who was at the time a commercial manager employed by Dŵr Cymru, and which is entitled “Common Carriage Application at Ashgrove, Deeside”. That document contains various matters relating to a proposed common carriage price to cover the partial treatment and transport of water through the Ashgrove system. The document is said by Dŵr Cymru not to be a Board paper as such, but was rather prepared for a Dŵr Cymru management committee known as the “licensed company executive” (“LCE”), hence its title “LCE/01/001”. Under the sub-heading “pricing” in LCE/01/001, Mr. Holton stated as follows:

“• [Dŵr Cymru’s] clean water service is segmented into: resource, treatment, bulk distribution, local distribution and customer service. The services requested by [Albion] are treatment to a non-potable standard (as present) and bulk distribution.

- [Dŵr Cymru's] current position on common carriage pricing is to use whole company averages. [Albion does] not believe this is an appropriate method and are demanding de-averaged prices. [Albion] is saying that [Dŵr Cymru] has already de-averaged with other special agreement customers such as Corus.”

179. The document then set out a calculation of company-wide average costs and accounting information which produced an initial access price of 19.94p/m<sup>3</sup>. In this, Dŵr Cymru was calculating a common carriage price by reference to the average cost of supplying all non-potable customers in its water supply area. We have had regard to the point made by Dŵr Cymru that the calculations behind the First Access Price were not necessarily definitive. However, it is noticeable that at no point did the document make any reference to the existence and/or importance of a back-up potable supply for non-potable customers generally or the Ashgrove system in particular. Had Dŵr Cymru been concerned that the proposed common carriage arrangement could unravel the existing bulk supply agreement, and potentially have as its effect the non-recovery of the cost of the back-up potable supply, we would have expected the contemporary internal documents to refer to such concerns. Those documents support the conclusion that Dŵr Cymru had no such concerns.

180. Thirdly, we were referred in argument to correspondence between the parties relating to the Tribunal's main judgment and to the Authority's further investigation. Our general approach to the views expressed in correspondence post-dating the First Access Price, whether on behalf of Dŵr Cymru, or of Albion, is to be cautious (since it took place several years after the negotiations in question), and to look for corroboration, in particular from the contemporary documents, wherever possible. In its reply skeleton argument, and at the oral hearing, Albion referred us to a letter from Mr. Peter Jones, head of economic regulation at Dŵr Cymru, received by Albion on or around 5 December 2006. It included the sub-heading “Relevance of the Judgment to the 1999 Bulk Supply Price” and stated as follows:

“[I]t would have been over-simplistic to characterise a bulk supply price purely as the sum of a common carriage price plus the price of the water at source, because there are important differences between the economic characteristics of, and therefore the contracting arrangements which underpin, the transactions involved. For example, *had Albion proceeded with its common carriage proposal, contractual arrangements would have had to have been established to determine how “unders and overs” would have been dealt with, together with a separate arrangement for dealing with the potable back-up to the Shotton Paper site.*” (emphasis added)

181. This passage demonstrates that, had the parties entered into a common carriage agreement, it was Dŵr Cymru's view, (which corresponded with Albion's expectation), that a separate arrangement for dealing with the back-up supply to Shotton Paper would be required. This clearly envisaged that the back-up supply would form part of a bulk supply agreement; such arrangements would be separate from, albeit related to, the common carriage proposal. Albion's case for excluding the back-up supply draws further support from a response by Dŵr Cymru to the Authority's information request of 27 February 2007 during the further investigation (see Annex A28 to the Report), which stated as follows:

[Question] "8. Dr. Bryan has stated that 'Shotton has to buy potable water (as a back up)'. What were the charges for the back up price in 2000-01 and did you include these in the First Access Price? Please explain how you think this back-up service should be accounted for in any new access price?"

...

[Answer] "In the event that Dŵr Cymru were unable to supply the full 18 Ml/d of non potable water [at] any time, Albion Water could use potable water to make up the shortfall, but would only pay the non-potable price. The agreement therefore provided two benefits to Albion Water, the 'standby' service of up to 8 Ml/d and the fact that potable water supplied to make up the 18 Ml/d entitlement would only be charged at non-potable rates. Neither benefit was priced for separately in the bulk supply agreement. Effectively, therefore they were 'bundled' together with the basic water supply service in one volumetric price.

*The First Access Price did not include any allowance for either benefit. By definition, since Dŵr Cymru's role would have changed from 'supplier' to 'common carrier', the various services that were included in the bulk supply agreement would automatically have become 'unbundled'. The basic supply of non-potable water to the Shotton site would have become Albion's responsibility. Whether or not Albion would have required ... [and then there are three possibilities]... is not known. Further, whether or not such services would have been negotiated as part of the access agreement (and therefore a single pricing agreement), or as separate agreements, is not known. However, Dŵr Cymru's preference at the present time would be for different services to be priced separately (whether as a single agreement or as separate agreements) because this provides transparency and offers better incentives. For any standby or 'top-up' supply it would seem logical to adopt a two-part structure, consisting of a 'reservation' element as well as a volumetric charge for the water actually taken. The levels of such charges would depend on the nature of the actual services required."* (emphasis added)

182. We recognise that those remarks were offered by Dŵr Cymru some time after the First Access Price was quoted. They also focused on the possible consequences of common carriage on the existing bulk supply arrangements. What was said about the First Access Price is, nonetheless, telling because it indicates that the access price for the

service of transportation and partial treatment of water by Dŵr Cymru did not provide or, in Dŵr Cymru's words, did not make "any allowance for" back-up supply. At the hearing, counsel for Dŵr Cymru sought to add a gloss to the words emphasised in the passage above. He submitted that what was in fact meant was that the First Access Price did not "explicitly" make any allowance for the back-up supply. On the evidence before us, we conclude the back-up supply should be regarded as a separate issue from the costs which the Authority was ordered to investigate.

183. Fourthly, as regards the Authority's reference to Dŵr Cymru's AAC calculation of the First Access Price as justifying its view that it implicitly included the cost of the back-up supply, the Tribunal has already found that methodology defective. As already noted, the Tribunal concluded in its main judgment that the matter of the "distribution" cost of non-potable water on an average accounting cost basis had not been sufficiently investigated. It follows that it is not possible to pray in aid the original methodology to justify the inclusion of the back-up supply.
184. Fifthly, the back-up supply was omitted from the stand-alone calculations by Dŵr Cymru and the Authority to indicate what it would have cost a hypothetical new entrant to build and operate a new system equivalent to the Ashgrove system from scratch in 2000/01.
185. Sixthly, under the proposed common carriage arrangement, Dŵr Cymru would no longer be a supplier to Shotton Paper's boundary, but a supplier of non-potable water transport and partial treatment services to Albion. The consequence is that the First Access Price quoted to Albion should have contained all the costs to be incurred by Dŵr Cymru but not therefore including the cost of the water, or any retail activities, nor any costs attributable to a potable bulk supply agreement. We have taken account of the fact that, by its very nature, a common carriage access price does not necessarily include a back-up supply (Report, paragraph 5.60). This is so, *a fortiori*, in cases where the available evidence tends to indicate that such a service would have been negotiated as a separate agreement. We express no view on whether a separate agreement would have been feasible or commercially desirable in 2000/01, particularly because it is not clear whether Albion could have sought more cost-effective, alternative sources of back-up supply. The point, for present purposes, is that it may be inferred from the

nature of the basic requirements for common carriage, as well as from the contemporary evidence cited above, that the provision of a back-up supply was not part of the common carriage services at issue in the present case.

186. Seventhly, we note that the terms on which Dŵr Cymru offered a revised bulk supply agreement in November 2007 included a fixed charge for the back-up service that would be provided under that agreement. This reinforces our view that the parties are treating, and in all likelihood treated, the back-up supply as a separate service from the treatment and transportation services on which the First Access Price was based.

187. The Tribunal is of the view that Albion has established that a back-up supply should have been excluded from the AAC+ and LAC calculations. While it is common ground that Albion may well have required access to a back-up supply, we do not consider that the costs of that service were “reasonably attributable” to the partial treatment and transportation of non-potable water through the Ashgrove system. In our view, such transportation costs should be distinguished from costs relating to any potable supply arrangements. Including an additional sum in respect of a back-up (potable) supply would distort any comparison with the First Access Price, which was based on the overall costs of treatment and distribution of non-potable water.

188. That being our conclusion, we need not decide on the alternative submission relating to the quantum of the cost of the back-up supply. It is only necessary for us to find that the back-up supply is not a relevant cost for the purposes of assessing the fairness and therefore the legality of the First Access Price.

189. We are satisfied that our findings on the various cost elements are a sufficient basis on which the *United Brands* questions can be determined. However, we would emphasise that these should not be taken to be the sum of our concerns at the cost justifications advanced. Other components of cost which we believe may also have been overstated include stranded assets, water storage and common services including management charges. Had it been necessary, we would have examined in greater depth further issues relating to the estimation of operating costs and capital values. However, given our findings on the first *United Brands* question (see section X below), we restrict the scope, detail and length of our judgment accordingly.

## X. THE FIRST UNITED BRANDS QUESTION: WAS THE FIRST ACCESS PRICE EXCESSIVE?

190. The judgments in *United Brands* and subsequent cases demonstrate that unfairly high pricing cannot be established without first showing excessive pricing: the two are not synonymous. In the absence of a price which represents more than a reasonable return on the cost of supply, there can be no case of excessive (still less unfair) pricing. Even so, the fact that a dominant firm charges a price which may not be cost based and enjoys a high profit margin does not *necessarily* mean that its conduct is abusive (see Mummery LJ in *Attheraces*, at paragraphs [207]-[209]).

191. In *Scandlines Sverige AB v Port of Helsingborg* (COMP/A.36.568/D3) [2006] 4 CMLR 1298 (“*Scandlines*”), the Commission rejected a complaint by a ferry operator, Scandlines Sverige AB, alleging that the owner of the Port of Helsingborg, Helsingborgs Hamn AB, had infringed Article 82, by levying excessive and discriminatory charges for services provided by the port to ferry operators. By letter to Scandlines Sverige of 18 February 2003 pursuant to Article 6 of Regulation No 2842/98 (OJ 1998 L 354, p. 18)<sup>7</sup>, the European Commission announced its intention to take no further action on its complaint (“the Article 6 letter”). In that letter the Commission drew the preliminary conclusion that:

“the mere fact that revenues may exceed costs actually incurred is not sufficient to conclude that the difference is “excessive” in the meaning of the first question posed by the Court in paragraph 252 of the *United Brands* judgment.” (paragraph [142] of the final decision.)

192. The Commission ultimately decided that there were insufficient grounds for acting on Scandlines’s complaint. In reaching its final decision the Commission observed:

“149. In paragraph 252 of the *United Brands* judgement, the Court made a clear distinction between, on the one hand, the question whether the difference between the price and the production costs – the profit margin – is “excessive” and, on the other hand, the question whether the price is unfair. Had it been otherwise, there would have been no reason for the Court, once the first question has been

---

<sup>7</sup> Article 6 provided: “Where the Commission, having received an application made under Article 3(2) of Regulation No 17 ..., considers that on the basis of the information in its possession there are insufficient grounds for granting the application or acting on the complaint, it shall inform the applicant or complainant of its reasons and set a date by which the applicant or complainant may make known its views in writing.” With effect from 1 May 2004 Article 6 was replaced by Article 7(1) of Regulation No 773/2004 (OJ 2004 L 123, p. 18).

answered in the affirmative, to proceed to the question whether the price is unfair in itself or when compared to the price of competing products.

150. A comparison between the price charged and the costs incurred (in the present case, the *approximate* incurred costs) can only serve as a first step in an analysis of excessive or unfair pricing. The United Brands judgment made clear (in paragraph 250) that such an abuse can only be established where the price bears no reasonable relation to the economic value of the product concerned.”

193. It was common ground between the parties that, in dealing with this first question, the “extent” of the excess in any given case involves a proper degree of discretionary judgment by the decision-maker (see main judgment, paragraph [310]). Counsel for Albion referred us to the judgment on remedy in *Genzyme Ltd v Office of Fair Trading* [2005] CAT 32, [2006] CompAR 195, in which the Tribunal addressed the degree of precision required in cost analysis:

“277. Although we consider that the OFT’s detailed costs studies should play a substantial part in our assessment, we do not consider that those studies should be the sole determining factor. Estimates and allocations of costs will always have a degree of arbitrariness.

...

279. The actual margin to be set is not a matter of precise mathematics.”

194. Thus the first *United Brands* question requires us to exercise our judgment as to whether the relationship between the disputed price and the relevant costs is excessive or not.

195. In accordance with our findings on the case for the inclusion or exclusion of the various cost components considered in section IX above, we have calculated the revised costs of supply under the AAC+ methodology as follows:

- (a) The costs reasonably attributable to the service of the transportation and partial treatment of water by Dwr Cymru generally, were 15.8p/m<sup>3</sup>: calculated by deducting from the Authority’s revised figure of 20.5p/m<sup>3</sup> the cost of back-up supply (4.4p/m<sup>3</sup>) and the cost of sludge disposal (0.3p/m<sup>3</sup>);
- (b) The costs reasonably attributable to the service of the transportation and partial treatment of water by Dwr Cymru through the Ashgrove system in particular were 13.8p/m<sup>3</sup>: calculated by taking the Authority’s revised figure of 20.5p/m<sup>3</sup> and then



deducting the cost of back-up supply (4.4p/m<sup>3</sup>), the cost of distribution pumping (2.0p/m<sup>3</sup>) and the cost of sludge disposal (0.3p/m<sup>3</sup>).

196. As regards the LAC methodology, we started with the revised figure of 19.2p/m<sup>3</sup> and then deducted the cost of the back-up supply (4.4p/m<sup>3</sup>) and the cost of sludge disposal<sup>8</sup> (1.2p/m<sup>3</sup>), to give a cost of supply of 13.6p/m<sup>3</sup>. The cost of distribution pumping had been, correctly, excluded from the Authority's LAC calculation.

197. The results of those adjustments and hence the minimum extent to which the First Access Price exceeds the costs calculated by the AAC+ methodology, as cross-checked by the results of the LAC methodology are set out below:

| <b>Methodology for calculating the costs of the supply of non-potable water</b> | <b>Result of methodology</b> | <b>First Access Price</b> | <b>Minimum percentage by which the First Access Price exceeds cost</b> |
|---|------------------------------|---------------------------|--|
| AAC+<br>(non-potable users generally)   | 15.8p/m <sup>3</sup>         | 23.2p/m <sup>3</sup>      | 46.8%  |
| AAC+<br>(Ashgrove system)   | 13.8p/m <sup>3</sup>         | 23.2p/m <sup>3</sup>      | 68.1%  |
| LAC<br>(Ashgrove system)  | 13.6p/m <sup>3</sup>         | 23.2p/m <sup>3</sup>      | 70.6%  |

198. Even allowing for the unavoidable uncertainties in the costs calculation, there is a clear disparity between the First Access Price and the cost of the services to be supplied (at a reasonable profit). We therefore find that the First Access Price exceeds the cost reasonably attributable to the service of the transportation and partial treatment of non-potable water by Dŵr Cymru, generally and through the Ashgrove system in particular.

199. The term 'excessive' is an ordinary English word, which may be applied in accordance with its ordinary meaning, having regard to the overall purpose of the Chapter II

<sup>8</sup> The cost of sludge disposal was calculated by adding 1.0 p/m<sup>3</sup> referred to in paragraph 9.34 of the Report and 0.2 p/m<sup>3</sup> in paragraph 23 of the Response of the Authority of 18 December 2007.

prohibition. We note that the Authority submitted that a price may not be “excessive” within the meaning of the first *United Brands* question where the price exceeds costs but not by a material extent (see paragraph 11.3 of the Report). While we are prepared to accept that a material difference between price and cost must be shown, we see no need to specify, in this case, when a particular difference is sufficiently large to be deemed excessive. In our judgment, a price at least 46.8% above the costs reasonably attributable to the supply of non-potable water to non-potable users generally is material and excessive. The same is true of a price at least 68.1% above the costs reasonably attributable to the supply of non-potable water through the Ashgrove system in particular.

200. We find, on the balance of probabilities, that Albion has established that the First Access Price was excessive when compared with the costs reasonably attributable to the service of the transportation and partial treatment of non-potable water by Dŵr Cymru, generally and through the Ashgrove system in particular.

## **XI. THE SECOND UNITED BRANDS QUESTION: WAS THE FIRST ACCESS PRICE UNFAIR?**

### **A. PARTIES’ SUBMISSIONS**

#### *Albion’s submissions*

201. It was Albion’s case that the First Access Price was unfair in the sense described in *United Brands*, as it bore no relation to the economic value of the services provided by Dŵr Cymru to Albion. Albion recognised that the issue of excessive pricing raised a number of difficulties of principle as well as practical application, but submitted that it was appropriate for the Tribunal to adjudicate on facts such as these, in particular where the market does not generate a competitive price.
202. Albion submitted that: (a) the First Access Price was in no way reflective of the relevant costs; (b) Dŵr Cymru was and continues to be a monopolist in a network industry protected by high barriers to entry; (c) the First Access Price was both exploitative and exclusionary in the sense that it was unfair to the immediate customer and end-consumer and excluded new entry competition; (d) the abuse was deliberate because the contemporary documents show that Dŵr Cymru was well aware that the

First Access Price would undermine the viability of Albion’s proposal; (e) the attitude of Shotton Paper, as an end-consumer, was relevant to the question of abuse (and is set out at paragraphs [119] to [127] of the main judgment); and (f) “the preponderant share of the overall profits of this business enjoyed by Dŵr Cymru” (paragraph 99 of Albion’s skeleton argument of 25 January 2008) was highly relevant, and, logically, so too was the margin squeeze abuse. In these circumstances, Albion submitted, there was a clear basis for the Tribunal to find that the First Access Price constituted an unfairly high price and thus an abuse of a dominant position.

203. Of the various European cases that have addressed excessive pricing, counsel for Albion submitted that *Deutsche Post AG – Interception of cross-border mail* (OJ 2001 L 331, p. 400) was probably closest to the present case. Albion referred to the contextual factors on which the Commission had relied in finding an abuse: Deutsche Post’s status as a monopolist; and the peculiarities of postal services, in particular the very low margins for bulk mailings. Albion submitted that those two factors, i.e. monopoly power and low margins, should be taken into account in deciding what level of excess is to be regarded as abusive.

204. Albion further submitted that *Attheraces* should be distinguished from the present case. *Attheraces* concerned a highly profitable and potentially competitive market in which both the British Horse Racing Board and Attheraces were making significant profits (see paragraph [214] of the judgment of the Court of Appeal). The present case is one where the very high common carriage price quoted by Dŵr Cymru as a monopoly supplier would mean that it retained the entire 87% gross margin between the retail price to be paid by Albion and the input price paid to United Utilities.

205. Albion agreed with the Authority that there were no examples of other supplies by Dŵr Cymru, or equivalent supplies by other water companies to serve as appropriate comparators with the Access Price quoted in this case.

#### *Dŵr Cymru’s submissions*

206. Dŵr Cymru submitted, first, that the second *United Brands* question did not arise since the costs reasonably attributable to providing the services in question exceeded the First Access Price. In the alternative, Dŵr Cymru submitted that the question whether a

particular price is unfair is a matter of judgment that has been assessed “in the round” by the expert regulator. It thus endorsed the Authority’s conclusion that the First Access Price was not unfair.

207. In the further alternative, Dŵr Cymru claimed that the Authority’s overall conclusion was reinforced by the fact that it made a number of errors to Dŵr Cymru’s disadvantage on the question of fairness. Dŵr Cymru submitted, in particular, that the Authority: (a) set itself an unreasonably high standard of accuracy for the use of cost comparators and ignored or failed to investigate comparators that were *prima facie* evidence that the First Access Price was not excessive; (b) wrongly rejected the relevance of indicative access prices of other water undertakers as relevant comparators; and (c) erred in finding that there were no relevant non-cost factors in this case that would cause the economic value of the service to be recognised as greater than the cost of supply alone. Rather, it claimed the following should be taken into consideration: the replacement value of the Ashgrove system; the effects of the framework of economic regulation in place in 2000/01; the social or economic desirability of regional average pricing; and the return on capital employed on the Ashgrove system compared with rates of return across similar industries.

*The Authority’s response*

208. The Authority’s view was that the costs reasonably attributable to the relevant services represented the “economic value” of those services, consistent with the implicit approach of the Commission in its decision in *Deutsche Post* (see paragraph [203] above). The Authority did not consider that there were any relevant non-cost-related factors which could raise the “economic value” of the relevant services above the measured costs.
209. While the Authority considered that an excess of 25% could well indicate that the First Access Price was unfair in itself, it did not consider that an excess of 20%, as calculated under the AAC+ methodology, was unfair in itself, in the circumstances of this case, and having regard to the fact that on one cross-check methodology the excess was 16%. The Authority did not consider that there was cogent evidence, in the circumstances of this case, that the excess was, on the balance of probabilities, unfair in itself. In reaching that conclusion, the Authority had regard to the considerable uncertainty over

the scope of the services to be provided by Dŵr Cymru for which the First Access Price was the consideration; the complexity of the costs allocation and the inherent uncertainty of the assumptions involved; the lack of any benchmark for a reasonable profit margin in these circumstances; and the fact that negotiations over the common carriage arrangement had not been completed by the time of the First Access Price.

210. The Authority also concluded that the First Access Price could not be assessed by reference to comparators. The large number of material differences between the First Access Price and available comparators made it difficult for meaningful comparisons to be made with individual prices charged for the supply of other water (whether potable or non-potable) by Dŵr Cymru or others.

#### B. PRELIMINARY OBSERVATIONS ON UNFAIR PRICING

211. While from an economic point of view, a monopoly may be assumed to charge a price which maximizes its profit and which is higher than it would be able to charge in a competitive market, in practice this may result in the imposition of unfairly high prices on customers or consumers. Section 18(2) of the Act specifically identifies unfair prices as an example of abuse of a dominant position, without going any further as regards definition. However it follows that one of the purposes of Chapter II is to prohibit unfairly high prices which, if that prohibition did not exist, a monopolist might charge in order to exploit its privileged position to the detriment of its customers and/or end consumers.

212. The Chapter II prohibition is not intended to prevent the market from self-correcting unduly high prices. In *Attheraces* (paragraphs [119] and [215]) it was held that the law on abuse of a dominant position is about distortion of competition and safeguarding the interests of consumers in the relevant market. There is no mandate to equate “normal and effective competition” in paragraph [249] of *United Brands* with the concept of perfect competition. It is not about high prices as such. Case law does not offer a simple rule against which any price above an appropriate measure of cost may be deemed unfair (*Attheraces*, paragraph [207]).

213. Contrary to Dŵr Cymru’s contention in paragraph 45 of its reply skeleton, factors that establish a dominant position, notably barriers to entry, may well be relevant to

determining whether a price is so high as to amount to an abuse by an undertaking of its dominant position. This is particularly true in excessive pricing cases, in which it is important to distinguish excessive prices shielded from effective competitive pressure from temporarily high prices that are the subject of normal market forces in a competitive market (see paragraphs [266]-[270] below).

214. The parties directed the Tribunal to a number of authorities, including the relevant parts of *United Brands*. The relevant case law is summarised in Bellamy & Child, *European Community Law of Competition*, 6th edition, at paragraphs 10.105 to 10.110. No authority was cited to us, and we are not aware of any authority, in which the lawfulness or otherwise of an access price in the water industry has been considered by the Community, or domestic, courts.

215. The parties agreed that the test to be applied in the present case was that laid down by the ECJ in *United Brands*. As already noted, in that case, the Court indicated (in relation to a product, rather than a service) that it is necessary to consider whether the difference between the costs actually incurred in “producing” the product and the price actually charged is excessive and, if the answer to that question is in the affirmative, whether a price has been imposed which is unfair in itself or when compared with competing products (*United Brands*, paragraph [252]).

216. The test laid down by the ECJ, like the prohibition in Article 82 itself, contains words – “bears”, “reasonable”, “relation” – which lack precision. Their practical application depends on the legal and economic context. It follows that there is no single correct measure of the ‘economic value’ of an asset such as the Ashgrove system. As the Tribunal has already held in paragraph [310] of the main judgment, and as the parties have accepted in their pleadings, whether a given price bears “no reasonable relation” to its “economic value” is a matter of degree, which involves a considerable margin of appreciation, not least because the concept of “economic value”, and whether the price has a “reasonable” relation to that value, are matters of judgment.

217. The intention of the Act is not to prohibit the adoption of methods that characterise the normal competitive process. Provided it behaves reasonably and proportionately, an undertaking in a dominant position may act in a profit-oriented way in a legitimate

drive to expand its business activities. However, a dominant undertaking has a special responsibility, irrespective of the causes of dominance, not to allow its conduct to impair effective competition in the relevant market (see Case 322/81 *NV Nederlandsche Banden Industrie Michelin v Commission* [1983] ECR 3461, [1985] 1 CMLR 282, paragraph [57]). The actual scope of the special responsibility imposed on a dominant undertaking must be considered in the light of the specific circumstances of each case (*Napp*, cited at paragraph [18] above, paragraph [219]). That responsibility is founded upon one of the objectives of the Chapter II prohibition.

218. In deciding whether there has been an abuse of a dominant position, the legitimate commercial interests of the dominant undertaking must be carefully weighed against the public interest in the maintenance of effective competition and protection of the consumer interest. We bear in mind that the primary interest to be protected under the Chapter II prohibition is that of the consumer, rather than the private interest of a particular competitor. However, as the Tribunal pointed out in *Burgess (t/a JJ Burgess & Sons) v Office of Fair Trading* [2005] CAT 25, [2005] CompAR 1151, at paragraph [332], there are some circumstances in which the protection of the competitive process involves the protection of an equally efficient competitor.

219. The arguments before us raised numerous other issues on which no decision is necessary. However, we should address briefly a subsidiary point concerning the competitive status of Albion, out of deference to a submission made by counsel for United Utilities. It relates to whether a competitor can be an alleged victim of an excessive pricing abuse. Counsel for United Utilities submitted that because an excessive pricing abuse is exploitative in nature, it can only be found in respect of a customer. The Tribunal has already held that Albion was the victim of a margin squeeze abuse. This shows, it was said, that Albion was acting as a competitor and thus cannot be the victim of unlawful excessive pricing. We note that the point was not supported by either the Authority or Dŵr Cymru. Albion took issue with it and referred us to the CFI judgment in Case T-5/97 *Industries des Poudres Sphériques v Commission* [2000] ECR II-3755, [2001] 4 CMLR 1020 where the complainant was both a competitor and a customer. A competitor is unlikely to complain about the excessive prices being charged by the dominant firm because those prices would normally create the potential for market entry. However, in the present case, Albion is

not only a competitor of Dŵr Cymru at the retail level but is also one of its customers. Plainly, a common carriage price which bears no reasonable relation to the economic value of the service provided can be an abuse of a dominant position; it does not depend on whether the victim is a competitor and/or a customer or whether the abuse is classified as exclusionary or exploitative or, as in this case, both.

### C. THE ECONOMIC VALUE OF THE SERVICES TO BE SUPPLIED

220. Consistent with part of the rationale in *United Brands*, the parties were agreed that unfairness in access pricing should be assessed by reference to the relationship between price and the “economic value” of the services to be supplied.
221. The concept of economic value is described as follows in Bellamy and Child, *European Community Law of Competition*, 6th edition, at paragraph 10.109:

“This directs attention to the nature of the product itself and the circumstances in which it is used by the purchaser. For some products, ‘economic value’ needs to reflect many factors other than the seller’s costs of what is being supplied, which in some cases may be minimal. To charge for the supply of copyright works a royalty calculated as a percentage of the turnover or profit made by the [publisher] is standard practice; whereas such a royalty could be abusive if the rate was excessive, it could not be contended that this method of charging was abusive solely on the ground that it is unrelated to the supplier’s cost of production. Similarly, when a sporting body or association sells the broadcasting rights to its events, what is supplied is essentially a licence to enter the stadium or film, the cost of which to the supplier is negligible.”

222. The European Commission (in *Scandlines*) and the Court of Appeal (in *Attheraces*) have both stated that the concept of economic value does not necessarily, or always, imply a cost-based approach, still less according to any particular measure of cost. It is clear that the economic value of a product or service should take account also of relevant “non-cost-related factors”, i.e. factors other than the cost of supplying a product or service but which mean that a product or service has a particular enhanced value from the customer’s perspective. In *Scandlines* the Commission stated at paragraph [226]:

“Moreover, the “cost-plus approach” suggested by *Scandlines* only takes into account the conditions of supply of the product/service. The determination of the economic value of the product/service should also take account of other non-cost related factors, especially as regards the demand-side aspects of the product/service concerned.”



(See also paragraphs [228] and [232] of the decision).

223. In *Attheraces*, the Court of Appeal noted that it would be wrong to read the judgment in *United Brands* too literally; rather it should be read and applied with care. The Court of Appeal continued:

“116. First, the judgment in fact poses two questions. The first is whether the difference between the costs actually incurred and the price actually charged is excessive. The second question is whether, if the first question is answered affirmatively, a price has been imposed which is either unfair in itself or when compared to competing products. BHB contends that the judge wrongly conflated the two questions into a single question, namely whether the charges specified by BHB were excessive.

117. Secondly, the central concept in abuse of dominant position by excessive and unfair pricing is not identified as the cost of producing the product or the profit made in selling it, but as the “economic value of the product supplied.” The selling price of a product is excessive and an abuse “if it has no reasonable relation to its economic value”.

118. Thirdly, the court did not say that the economic value of a product is always ascertained by reference to the cost of producing it plus a reasonable profit (cost +), or that a higher price than cost + is necessarily an excessive price and an abuse of a dominant position. The court was indicating that one possible way (inter alia) of objectively determining whether the price is excessive and an abuse is to determine, if the calculation were possible, the profit margin by reference to the selling price and the cost of production.”

224. In *Attheraces* the Court of Appeal held that the judge at first instance had taken too narrow a view of economic value of the product supplied (UK pre-race data) by the British Horseracing Board. In particular, the judge had taken insufficient account of the value of that pre-race data to *Attheraces* in determining the economic value of that product and hence whether the charges specified by the Board were excessive and unfair. In the present case, the parties drew the Tribunal’s attention to the passages in the judgment of Mummery LJ at paragraphs [203] *et seq.* From these a number of principles emerge:

- (a) Subject to what is envisaged by Article 82 EC, the economic value of a product or service is what it would fetch (paragraph [205]).
- (b) Article 82 and the Chapter II prohibition proceed from the premise that the undertaking has a dominant position enabling it to distort the market in

which it operates. Dominance may have the effect of distorting the economic value of the product or service (paragraph [205]).

- (c) It does not follow that whatever price a seller in a dominant position exacts, or seeks to exact, is necessarily an abuse of his dominant position (paragraph [206]).
- (d) The economic value of a product is a different concept from its cost. Although a comparison between price and cost of supply (plus a reasonable return) may be a first step in the analysis of economic value, it is not conclusive on the question of unfair pricing and the existence of an abuse (paragraphs [207], [209] and [213]).
- (e) It is relevant to consider whether the customer's competitiveness had been, or was at risk of being, materially compromised by the terms of supply (paragraphs [215] and [217]).
- (f) The possibility remains of "a monopoly supplier not quite killing the goose that lays the golden eggs, but coming close to throttling her" being held to be abusive (paragraph [217]).

225. Dŵr Cymru sought to argue that the determination of the economic value of the product *must* take into account non-cost-related factors, and that the factors which may be relevant have not been exhaustively specified in the case law. We do not dispute Dŵr Cymru's submission that it is important to examine whether there are any non-cost related factors in a particular case. However this does not rule out the possibility that the costs of supplying a product or service (plus a reasonable return) would, in the absence of any relevant non-cost-related factors, represent its "economic value". Nor is there any suggestion that the Court of Appeal intended to rule out such a possibility by its judgment in *Attheraces*. If Dŵr Cymru's submission amounts to more than this – for example, that non-cost-related factors must be reflected in the economic value even if irrelevant or non-existent in the particular circumstances of a case – then it seems to us that it is not supported by the authorities to which our attention has been drawn, and is inconsistent with the judgment in *United Brands* and Article 82 EC itself. In our view, the Authority was correct to observe at paragraph 12.61 of the Report that neither *Scandlines* nor *Attheraces* "excludes the possibility that, in the absence of relevant non-cost-related factors, the very excessiveness of a price could be sufficient to establish

that the price bears no reasonable relation to the economic value of the product/service being provided.” This approach is also consistent with that taken by the European Commission in *Deutsche Post* (see paragraph [203] above).

226. We note that *Attheraces* concerned the charge imposed by The British Horseracing Board Limited for use of its pre-race data by overseas bookmakers, and that the Court of Appeal concluded that a narrow focus on the cost of production was insufficient in that case. The pre-race data was of considerable value to Attheraces as the customer and for which it was readily willing to pay a premium (paragraphs [212] to [218] of the judgment of the Court of Appeal). An analysis of willingness to pay a premium may be relevant in some cases. This case is different, since the rationale of common carriage is to enable effective competition to develop in the water industry<sup>9</sup>. The Tribunal notes that: first, Albion remains willing and able to pay a reasonable common carriage price. Secondly, Albion is proposing to add value to the common carriage services to be provided by Dŵr Cymru. Thirdly, unlike the situation in *Attheraces*, the First Access Price has led both to a distortion of competition and to an adverse effect on the end user (see paragraphs [772] to [774] of the main judgment and paragraphs [271] to [273] below). In this case, Albion is not a willing purchaser at the First Access Price. Under the Second Bulk Supply Agreement, Albion is paying Dŵr Cymru’s price under protest and benefiting from interim relief given by the Tribunal, without which it might not have remained in the market. Shotton Paper wishes to contract with Albion and expects various benefits. The First Access Price would place the proposed common carriage arrangement in jeopardy and constitute a significant distortion of the competitive process. Fourthly, in any event, no attempt has been made by the Authority or Dŵr Cymru to quantify the intangible value of the claimed benefits additional to the service itself.

227. The four non-cost related factors which Dŵr Cymru suggested were relevant to the assessment of economic value in this case were: (a) the extent of the sunk costs (and any intangible value) of the Ashgrove system; (b) the effects of the framework of economic regulation in place in 2000/01 and the social or economic desirability of

---

<sup>9</sup> See, for example, MD 163: the Director’s letter to managing directors of all water and sewerage companies and water only companies regarding pricing issues for common carriage dated 30 June 2000, available at <http://www.ofwat.gov.uk/>.

regional average pricing; (c) the return on capital employed at Ashgrove compared with rates of return across similar industries; and (d) if excluded from the costs calculation used to answer the first *United Brands* question, the cost of the back-up supply.

*The extent of the sunk costs (and any intangible value) of the Ashgrove system*

228. Dŵr Cymru's skeleton argument referred to (and relied on) submissions which had been made on its behalf to the Authority during the further investigation (for example, the letters from Wilmer Hale LLP of 27 February, 30 March and 16 May 2007). One of those submissions was that the extent of sunk costs and any intangible value of the Ashgrove system are not represented in the regulatory or management accounts. Dŵr Cymru submitted that account should be taken of the MEAV of the Ashgrove system in assessing the economic value of the service to be received by Albion from Dŵr Cymru. It referred to the Commission's decision in *Scandlines*, to which the Tribunal must have regard under section 60(3) of the Act.

229. In the Article 6 letter (see paragraph [191] above), the Commission listed three elements which could be taken into consideration when assessing the economic value of the services provided by the port to the ferry-operators, as follows:

“- The port of Helsingborg has very high sunk costs, which are not accounted for in the audited financial reports of HHAB or the city of Helsingborg. The Commission argued in the Article 6 letter that if the port would have to rebuild the existing installations used by the ferry-operators from scratch, or if it were envisaged to build a new ferry-port at the same location, the costs incurred by such a port to provide exactly the same level of services and facilities to the ferry operators would be far higher than the costs presently accounted for by HHAB.

- The ferry-operators benefit from the fact that the location of the port of Helsingborg meets their needs perfectly. The Commission argued in the Article 6 letter that this represents an intangible value in itself, which could be taken into account as part of the economic value of the services provided by HHAB, and which is not reflected in the accounts of HHAB.

- The Commission argued that the land used by the port for the ferry-operations is very valuable in itself. Keeping the ferry-operations there instead of using the land for other purposes is likely to represent an opportunity cost for the City of Helsingborg (the unique shareholder of the port).” (paragraph [209].)

230. In view of the above considerations, the Commission drew the preliminary conclusion that the economic value of the services should be considered to be much higher than the

costs accounted for by the port to provide port services to the ferry-operators. In its final decision of 23 July 2004, however, the Commission noted that it had substantially amended its assessment concerning whether the prices were unfair, and focused in its final decision on whether the port charges were unfair in relation to the economic value of the services provided by Helsingborgs Hamn AB (*Scandlines*, paragraph [212]). The Commission emphasised that the economic value of the product/service cannot simply be determined by adding to the costs incurred in the provision of this product/service a profit margin which would be a pre-determined percentage of the production costs (*Scandlines*, paragraphs [214], [221], [226], [228], [232], [233]). In reaching its final decision, the Commission focused on the demand-side aspects of the port services, and in particular the fact that the Swedish port of Helsingborg represented a value to its customers because of its unique location close to a Danish port. The Commission took the view that this should be taken into account in the assessment of the economic value of the service provided by Helsingborgs Hamn and in its price. The Commission concluded that there was insufficient evidence to find that the port charges would have “no reasonable relation to the economic value” of the services provided to the ferry-operators. The disputed port charges could not therefore be found to be unfair in themselves.

231. The Tribunal understands Dŵr Cymru’s reasoning to be that that the common carriage proposal is valuable to Albion because it would save Albion the legal, physical and economic difficulties of constructing an alternative pipeline from Heronbridge. Any sunk costs and intangible value of the Ashgrove system should therefore be regarded as part of the economic value of providing common carriage services to Albion.
232. It is common ground that there has, in fact, been no alternative pipeline to the Ashgrove system, either from Heronbridge or from anywhere else. The Tribunal has already found that the prospect of a new pipeline being constructed in this case was “distant, theoretical and unrealistic in commercial terms” (see paragraphs [136] to [147] of the further judgment). It is also likely that it would be cheaper for a new entrant in the position of Albion to use common carriage for supplying water to Shotton Paper rather than build its own pipeline. Indeed, that is one of the reasons why the former Director General of Water Services, together with the OFT, regarded common carriage as an important means of introducing competition to the water industry:

“4.16 The Director regards ‘common carriage’ as the shared use of assets by undertakings. In many circumstances it would be uneconomic for a competitor to duplicate the provision of large assets, such as a pipe network or treatment facility. *Common carriage, therefore, has the potential to increase customer choice by facilitating the entry of competitors (whether existing undertakers or new entrants) into a local market.*

4.17 There is no specific statutory framework for common carriage, but this does not prevent undertakings from agreeing to such arrangements, including the associated terms and conditions. In general, however, incumbent undertakers may have little incentive to offer access to their facilities to other suppliers ... the imposition of unreasonable price or non-price terms for access could infringe the Chapter II prohibition.” (emphasis added)

Source: The Competition Act 1998: Application in the water and sewerage sectors (OFT 422, February 2000) (“the Guidance”)<sup>10</sup>

233. The economic value of common carriage to a user may, when considered in the abstract, take into account the fact that he avoids the cost and risk of having to build his own pipeline. However, it does not follow that this will always be the case. Any assessment of economic value of a product or service must take into account the particular circumstances of each case.
234. If, as envisaged by the Guidance (OFT 422), common carriage is to be an important means of introducing competition to the water industry, it is neither possible nor desirable to divorce the economic value of common carriage from the fact that this is a vertically integrated market. In contrast to the position in *Scandlines*, where the dominant firm (the owner of the port of Helsingborg) was not present on the downstream ferry services market, in this case, Dŵr Cymru is not only present on the upstream market for the transportation of non-potable water for supply to industrial customers in the geographical area served by the Ashgrove system, but is also active in the downstream market for the supply of non-potable water to industrial customers in that area. Whereas in the upstream market, Albion and Dŵr Cymru act as customer and supplier, Albion and Dŵr Cymru are actual or potential competitors in the downstream market. An excessive upstream price charged by a vertically integrated dominant

---

<sup>10</sup> At the time of this judgment, OFT 422 had not been amended or withdrawn. On 13 December 2007 the Authority issued a consultation document entitled “Guidance on the application of the Competition Act 1998 in the water and sewerage sectors” which is due to replace OFT 422. That document is available at <http://www.ofwat.gov.uk/> but does not refer to common carriage.

undertaking to customers which are also its competitors in a downstream market may have an exclusionary effect.

235. Where, as here, the functions of treatment, distribution and retailing of water are carried out within the same company – Dŵr Cymru, two kinds of prices are set: retail prices for services supplied to its own customers, and access prices for the use of its infrastructure. A crucial factor in determining the economic value of common carriage is the margin between the two prices set by Dŵr Cymru. The Tribunal has already found that Dŵr Cymru imposed an unlawful margin squeeze on Albion (see paragraph [312] of the further judgment).

236. The common carriage proposal in this case only has economic value to Albion if it means it is thereby able to provide water to Shotton Paper at a retail price that can effectively compete with the retail price offered by Dŵr Cymru in 2000/01 (i.e. 26p/m<sup>3</sup>). In the Tribunal’s judgment, it is the fact that Dŵr Cymru is a competitor of Albion in the downstream market, and therefore in a position to lower its own retail price to the level of its input costs, which means that the economic value of the service (here, common carriage) to its downstream competitors (here, Albion) may be equivalent to the costs reasonably attributable to the transportation and partial treatment of non-potable water. Were it otherwise, common carriage in the present case would be virtually unattainable, thereby frustrating the various attempts to introduce a degree of effective competition in relation to the supply of water to large users (as noted in paragraphs [295] to [302] of the main judgment).

237. The Authority put forward a further response to Dŵr Cymru’s submissions on this point. It was contended by the Authority that “using the MEA value of the Ashgrove system would appear to amount to carrying out another stand-alone cost calculation of the Ashgrove system” (Report, paragraph 12.72). At paragraph [573] of its main judgment the Tribunal rejected the relevance of the stand-alone cost calculations proposed by Dŵr Cymru and the Authority:

“[T]hese calculations were not what the Tribunal was looking for, and in our view have little relevance to the determination of the issues in the present case. What the Tribunal was looking for was more detailed information on the actual cost attributable to the Ashgrove system as it was at the material time, the period 2001 to 2004, not the cost that would be incurred on a venture capital basis by a

new entrant seeking to replicate the Ashgrove system from scratch as a ‘new build’.”

238. We consider that those observations apply equally to any assessment of the economic value of the services at issue in this case.

239. Therefore the Tribunal finds that the extent of the sunk costs (and any intangible value) of the Ashgrove system has not been shown materially to alter the economic value of the services that would have been received by Albion in using that system.

*The effects of the framework of economic regulation in place in 2000/01 and the social or economic desirability of regional average pricing*

240. The evidence before the Tribunal indicates that there was little, if any, regulation of the prices of non-potable water supplied to large industrial users and that such regulation as there was did not prevent Dŵr Cymru from charging the First Access Price which we have already found to be excessive.

241. Further, there is no suggestion that the First Access Price quoted by Dŵr Cymru was particularly influenced by the framework of economic regulation in 2000/01. Dŵr Cymru had sufficient discretion at the material time for its pricing policy to fall within the scope of the Chapter II prohibition. Equally, the alleged social and economic desirability of regional average pricing cannot be relied upon to enhance the economic value of the common carriage services requested by Albion. The Tribunal has already found that the prevailing practice of regional average pricing had not been adequately verified for the purposes of the Chapter II prohibition (see main judgment, paragraphs [631] to [637]).

242. As regards the need for regulatory approval of the First Access Price, even though Dŵr Cymru apparently believed it needed its access charges to be approved by the Authority, this does not absolve it from its special responsibility under the Chapter II prohibition. Even if the position of the regulator (in favour, at the material time, of access prices set according to regional average costs) and/or the relevant regulatory framework encouraged or made it easier for water companies to engage in anti-competitive conduct, those undertakings remained subject to the Act. We note that the Authority did not approve the First Access Price. In a letter to Dŵr Cymru on 1 March



2001 the Director stated that there was “no question of [the Authority] “approving” your charges – the onus is on Dŵr Cymru to comply with the Competition Act 1998”.

243. We also consider that Dŵr Cymru cannot rely on the Decision as having “approved” the First Access Price (Transcript of hearing, 15 February 2008, page 18, lines 23-24). The Decision was simply to the effect that the First Access Price did not constitute an abuse of a dominant position contrary to the Chapter II prohibition. Indeed, the Authority concluded that the price was excessive, even though not unfair. Furthermore, and in any event, the relevant parts of the Decision (including in particular paragraphs 300 to 302 dealing with the relationship between potable and non-potable costs, as well as paragraphs 338 to 341, containing the Director’s conclusions on excessive pricing) were set aside by sub-paragraph (i) of paragraph [360] of the further judgment.

*The return on capital employed on the Ashgrove system compared with rates of return across similar industries*

244. Dŵr Cymru submitted that any assessment of economic value should take into account what it claimed was the inherently more risky activity of supplying water to non-potable customers via the Ashgrove system on a stand-alone basis. The risk was said to be high because there was no obvious alternative use for the Ashgrove system apart from supplying Corus and Shotton Paper. The Tribunal notes that, in its response of 18 December 2007, the Authority included the risk of asset stranding in the cost of capital in the AAC+ and LAC methodologies. This was said to reflect regulatory practice that efficiently incurred investments should continue to be remunerated at the appropriate cost of capital.
245. As to Dŵr Cymru’s suggestion that greater risks (and stranded assets) arise if a new system equivalent to the Ashgrove system were to be constructed, that is not the case on the facts before us. The Tribunal is considering the economic value of the Ashgrove system as it was at the material time in 2000/01. Whether or not such a hypothetical project would be “high risk”, and might require a hurdle rate of return of 17½% before anyone would undertake it, for the reason contained in paragraphs [579] to [598] of the main judgment, the Tribunal does not accept that any such approach should be used as a basis for calculating the economic value of the Ashgrove system. We note in particular

that Dŵr Cymru has previously accepted that its stand-alone cost calculations should not be used for charging purposes: see main judgment, paragraph [583].

246. On the above basis, the economic value of the Ashgrove system should not include a rate of return which is comparable to that which would be required commercially on a stand-alone project. It is therefore not necessary for us to consider whether that higher rate of return is comparable with rates of return achieved in other similar industries.

*Should the economic value of the Ashgrove system reflect the cost of the back-up supply?*

247. At the hearing in February 2008, counsel for Dŵr Cymru submitted that the test for unfair pricing in *United Brands* required the Tribunal to consider two “buckets”: a “costs bucket” and an “economic value bucket”. Insofar as a measure of cost – in particular the back-up supply – was considered by the Tribunal to fall outside the “costs bucket”, then it was Dŵr Cymru’s contention that it must be taken into consideration in the “economic value bucket”.

248. Whatever the legal or practical merit of these two metaphorical buckets, we do not accept the suggested binary nature of that analysis. An irrelevant component of cost, or value, must fall outside both buckets. We have already found that the costs of the potable back-up supply were not “reasonably attributable” to the transportation of non-potable water through the Ashgrove system. It follows that the cost of back-up supply was not relevant to answering the first *United Brands* question. Further, it does not follow that the costs of this service should automatically be included in the determination of the economic value of the common carriage services. Because the potable back-up supply was not part of the service of transportation and partial treatment of non-potable water by Dŵr Cymru, the costs of the back-up supply did not, and cannot, form part of the economic value of those services. As noted above, this does not mean that the back-up supply is irrelevant for all purposes or that it should be ignored; it simply means that the back-up supply is not relevant in assessing the fairness of the First Access Price.

249. It follows from the foregoing that the economic value of the services to be supplied in this case was not more, or not significantly more, than the costs reasonably attributable

to the service of the transportation and partial treatment of water by Dŵr Cymru, generally and through the Ashgrove system in particular.

D. WAS THE FIRST ACCESS PRICE UNFAIR?

250. An excessive price will be an unfair price in terms of section 18 of the Act, and in particular subsection 18(2)(a), if the price that has been imposed is either unfair in itself or when compared to competing products.

*Was the First Access Price unfair in comparison to competing products?*

251. Dŵr Cymru submitted that, if the Tribunal were minded to conclude that the First Access Price was unfair, it would be incumbent on the Tribunal to revisit the issue of whether it was unfair in comparison to competing products before drawing any conclusions. Dŵr Cymru challenged the Authority's view that there were no relevant comparators in considering whether the First Access Price was unfair in comparison with competing products.

252. The Tribunal notes that products do not have to be identical for the purposes of the unfairness test. However, the comparator has to be sufficiently similar to the product concerned in order for any comparison to be meaningful. This point was articulated by the Commission in *Scandlines* at paragraph [169]:

“It may be possible in the abstract, as *Scandlines* suggests, to make a comparison between different figures representing prices of products or services. The problem is to assure that the comparison is valid and that the result of the comparison is meaningful. It must be ensured that the figures which are compared are really comparable. The conditions under which such a comparison is made are therefore of the utmost importance.”

253. The Commission continued at paragraph [175]:

“[A] comparison of the prices must be made on a consistent basis. This notably implies that:

- the products/services provided must be comparable; and
- the charging systems must allow a meaningful comparison.”

254. In the present case, we agree with the Authority that it is difficult to identify suitable comparators to act as a yardstick to measure the fairness of the First Access Price, for several reasons.

255. First, paragraph [252] of *United Brands* refers to a price which is unfair *either* “in itself” *or* “when compared to competing products” - an alternative, not a cumulative, requirement. It should be noted too that both the ECJ and the Tribunal have recognised that there may be other ways of determining whether the price is unfair: see *United Brands*, paragraph [253] and *Napp*, paragraph [391] respectively.
256. Secondly, as the Tribunal has already found in its further judgment, there is no substitute for the service of the transportation and partial treatment of water here in question (see paragraphs [102] to [107] and [250]). It is therefore impossible to compare the level of the common carriage price charged by Dŵr Cymru with that of direct competitors because there are none (see similarly the Commission’s decisions in *Deutsche Post*, paragraph [159]; *Scandlines*, paragraph [170]).
257. Thirdly, showing that a number of other water undertakers in England and Wales engage in similar access pricing practices at the material time does not, in itself, show that the First Access Price quoted by Dŵr Cymru was not unfair.
258. Fourthly, other bulk supplies, including those of potable water, provided by Dŵr Cymru are not reliable, or at least sufficiently reliable, comparators. In that regard, we refer to the reasoning set out in paragraphs [753] to [757] of the main judgment.
259. Fifthly, in the present case, the suggested comparators are not as directly applicable as those in *Napp*. Whereas in *Napp* the OFT compared Napp’s actual retail price in the community sector with: (a) actual retail prices charged by its competitors in the same market, and (b) actual retail prices charged by Napp in competitive markets; any attempt to compare the First Access Price and the retail tariffs charged by Dŵr Cymru to other non-potable users in 2000/01 (as set out in Table 22 of the Report) encounters a number of difficulties. The First Access Price, as its name implies, by definition should not include the costs of a retail activity. The Authority correctly noted the problems associated with identifying an appropriate access price by seeking to make “rough adjustments” to other retail prices that Dŵr Cymru charges (Report, paragraph 12.23). Moreover, as the Authority pointed out, there are important methodological differences between the derivation of the First Access Price and the derivation of retail prices for non-potable supply. In any event, it appeared that Dŵr Cymru did not have detailed

cost information on individual systems which could be used to calculate access prices for the four other non-potable systems (Report, paragraph 12.26).

*Was the First Access Price unfair in itself?*

260. In our judgment, the question whether an excessive price quoted by a dominant undertaking is to be regarded as unfair for the purposes of the Chapter II prohibition is a matter to be looked at in the round. As to the question whether the First Access Price was unfair in itself, the Tribunal has had full regard to the findings reached by the Authority in its Report; and has considered the relevant circumstances relating to the water supply in question.
261. As the parties have argued, and the Authority has accepted in paragraph 12.64 of its Report, the application of the *United Brands* test to a particular set of data involves a considerable margin of appreciation.
262. The Authority rightly observed that “neither the case law of the ECJ nor the decisional practice of the Commission purports to indicate any quantitative threshold, akin to, for example, a *de limitis* threshold, above which an excess over the economic value of a product/service could be said to bear no reasonable relation to the economic value of the service provided” (Report, paragraph 12.91). The Tribunal was, however, referred to the Commission’s decision in *Deutsche Post* (see paragraph [203] above). *Deutsche Post* deemed mail containing any reference to Germany (for example, the inclusion of a German reply address in the contents of the mail) to have a German sender and, accordingly, charged the full domestic tariff for such mail. The Commission decided that, by intercepting, surcharging and delaying normal cross-border mail in this way, *Deutsche Post* had abused its dominant position on the German market for the delivery of cross-border mail. Further, the Commission found that the price charged by *Deutsche Post* exceeded the average cost for delivering incoming cross-border mail by at least 25%, and that the price bore no reasonable relationship to actual costs or to the real value of the service provided.
263. The Tribunal agrees with the Authority that it would not be appropriate to specify a particular amount by which a price must exceed the economic value of a product or service in order to infringe the Chapter II prohibition. The measure of excess is not an

exact science and it is not practically possible to specify a precise arithmetic relation between price and the economic value of a product or service for it to be judged fair or unfair. Determining how far above “the economic value” a price has to be before it can be said to bear “no reasonable relation” to the economic value is a matter of judgment, having regard to the circumstances of the individual case.

264. The Tribunal has given detailed consideration to whether there are relevant non-cost related factors in this case, and has concluded that there are none. Further, in the Tribunal’s judgment, there is no reason why, in these circumstances, the cost of supply cannot be held to represent the economic value of the services being provided to Albion. In such circumstances “the excessiveness may in itself indicate that a price bears no reasonable relation to the economic value of the service being provided” (Report, paragraph 12.89). In order for an excessive price to be deemed unfair, however, it must, *inter alia*, be established that the price bears no reasonable relation to the economic value of the services to be supplied in this case (Report, paragraph 12.90).

265. In this case, we have found that the economic value of the non-potable water to be supplied, through common carriage, to Shotton Paper equates to the costs reasonably attributable to the service of the transportation and partial treatment of water by Dŵr Cymru. The size of the excess amounts to a minimum of some 46.8% on the basis of an average for non-potable users generally (using the AAC+ methodology) and 68.1% to 70.6% (using the AAC+ and LAC methodologies respectively) in terms of the costs of the Ashgrove system specifically (see paragraph [197] above). We note that, in the light of the Commission’s decision in *Deutsche Post*, the Authority considered that it was possible that an excess over costs of 25% or more could indicate that the First Access Price was unfair in itself (see paragraph 12.93 of the Report). In our judgment, even allowing for the unavoidable uncertainties in cost calculations, there is a substantial disparity between the First Access Price and the economic value of the services to be supplied in this case.

266. When assessing the relationship between the disputed price and the economic value of a service, and thus the potential unfairness of a price, we must take into account the competitive conditions and any related abusive conduct that may enable the undertaking concerned to fulfil its pricing ambitions (see paragraph [213] above).

267. The Tribunal analysed the competitive conditions in this case in section V of the further judgment. The Tribunal found that the factors summarised in paragraph [148] of the further judgment pointed overwhelmingly to the existence of a dominant position on the part of Dŵr Cymru. Those factors included the fact that Dŵr Cymru owned the infrastructure needed partially to treat and transport water to Shotton Paper. Moreover, any new entrant would have to develop an alternative infrastructure at a cost probably well in excess of that incurred by Dŵr Cymru in maintaining the Ashgrove system (paragraph [124]). Neither “self-supply” nor the construction of an alternative pipeline were, or could be, an effective competitive constraint on Dŵr Cymru’s pricing policy (paragraphs [129] to [147]). The suggestion in paragraph 209 of the Decision that there were potential competitors who could compete with Dŵr Cymru in the relevant market was, in the Tribunal’s judgment, entirely unfounded (paragraph [179]).

268. While the foregoing contextual factors do not in themselves establish the existence of an abuse, they do suggest that the Tribunal should review with care the lawfulness of a price which was unconstrained by any competitive considerations whatsoever (see the Opinion of Advocate General Jacobs in *Tournier*, paragraph [88] above, at page 2550; *Napp*, paragraph [219] and the main judgment, paragraph [801]). In particular, those factors inform our consideration of whether the relevant market is capable of functioning in a manner that is likely to produce a reasonable relationship of price to economic value of the services to be supplied.

269. Dŵr Cymru retained a market share of the 100% of the relevant market for the transportation and partial treatment of water throughout the period considered in the Report. A market share of this order, together with the existence of significant barriers to entry, is an indicator of competitive forces not operating in normal competitive conditions. In those circumstances, in quoting the First Access Price, Dŵr Cymru was able to act in the market for the transportation and partial treatment of water without regard to the position of its customer in the market, Albion, and also its competitor in the retail supply of water, and also without regard to the ultimate interests of Shotton Paper.

270. In our judgment, it follows that the relevant market was clearly not capable of functioning in a manner that produced, or was likely to produce, a reasonable

relationship between the First Access Price and the economic value of the services to be supplied at the material time.

271. Given the overriding purpose of the Chapter II prohibition (see paragraph [218] above), it is important for us to look, beyond Albion's immediate interests, to the customer to be served by Albion. As noted in paragraph [771] of the main judgment, Shotton Paper has supported Albion because it valued being able to choose its supplier. From the customer's point of view, choice in itself is one of the most important benefits that effective competition can provide. On the evidence in this case, the First Access Price would have placed Albion at such a disadvantage in relation to Dŵr Cymru, that its ability to compete would have been significantly compromised. Rendering Albion's business uneconomic would clearly disadvantage Shotton Paper by depriving it of the potential choice of supplier. Any other view would mean that the choice of water undertaker for Shotton Paper would be made by Dŵr Cymru, and not by Shotton Paper.
272. Had there been a reasonable relationship between the First Access Price and the economic value of the services to be supplied (i.e. in this case, a closer relation to attributable costs) Shotton Paper may have benefited from the introduction of lower retail tariffs for two reasons. First, the development of a competitive supply situation as regards the Ashgrove system would have been likely to bring about a closer relationship between prices and costs, and thus lower retail prices. Secondly, if there had been competition through common carriage, Shotton Paper may have been in a position to exert pressure on Dŵr Cymru and Albion to reduce prices or improve its proposed services.
273. The First Access Price might have the further effect of preventing Albion from offering water efficiency services to Shotton Paper. The evidence before the Tribunal indicated that Dŵr Cymru ceased to supply those services, as a result of the constraints imposed on the company by the Director's 1999 price determination. To the extent that the First Access Price prevents Albion from offering a water supply combined with water efficiency services, it prevents Shotton Paper from reducing its water consumption and thus saving on its water bills. This additional element further supports our finding of unfair pricing, for the reasons given in paragraphs [876] to [895] of the main judgment.



274. In the light of all of the foregoing, the Tribunal concludes that the First Access Price bore no reasonable relation to the economic value of the services to be supplied and was unfair. The First Access Price Dŵr Cymru proposed to charge Albion would have effectively insulated it from competitive pressure and/or enabled it to exploit its control over customers within its appointed area. In specifying that price, Dŵr Cymru made use of the opportunities arising from its dominant position so as to seek advantages which it should not be permitted under the Chapter II prohibition.

## **XII. CONCLUSION**

275. Section 18(2)(a) of the Act provides that conduct may constitute an abuse of a dominant position if it consists in directly or indirectly imposing unfair selling prices. As such, it is designed to protect parties to contracts with undertakings in dominant positions and consumers against exploitation of their dependence on the dominant undertaking. The Tribunal finds that Albion has established that in March 2001 Dŵr Cymru abused its dominant position by quoting a First Access Price which was both excessive and unfair in itself. Our finding of unfair pricing does not derive solely from an examination of the credibility of the claimed costs; it rests too on a number of other points, particularly the source of Dŵr Cymru's pricing power and the effect of the First Access Price on the competitive process and end-consumer.

276. We have heard no argument on the question of remedy. The Tribunal may "give such direction ... as the [Authority] could itself have given" under paragraph 3(2)(d) of Schedule 8 to the Act, provided the parties are given the opportunity to make representations. It is open to Dŵr Cymru and Albion to see if an agreed solution can now be reached. An opportunity for them to negotiate, in the light of the findings made by the Tribunal in this and earlier judgments, may well enable them finally to resolve this dispute, either directly or through mediation. Having said that, the Tribunal will hold such further hearings as are necessary.

Lord Carlile of Berriew Q.C.

Antony Lewis

John Pickering

Charles Dhanowa  
Registrar

Date: 7 November 2008