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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1042/2/4/04

Victoria House,
Bloomsbury Place,
London WC1A 2EB

20th June 2005

Before:
SIR CHRISTOPHER BELLAMY
(The President)

THE HONOURABLE ANTONY LEWIS
PROFESSOR JOHN PICKERING

Sitting as a Tribunal in England and Wales

BETWEEN:

ALBION WATER LIMITED

Appellant

And

DIRECTOR GENERAL OF WATER SERVICES

Respondent

supported by

THAMES WATER UTILITIES LIMITED

Intervener

Mr. Rhodri Thompson QC and Mr. John O'Flaherty appeared on behalf of the Appellant.

Mr. Jon Turner and Miss Valentina Sloane (instructed by the Director of Legal Services, OFWAT) appeared on behalf of the Respondent.

Mr. Stephen Tupper (of Watson, Farley & Williams) appeared on behalf of the Intervener.

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HEARING DAY TWO

1 MR. TURNER: May it please the Tribunal, as I was saying in opening yesterday, what you have is
2 effectively a challenge to the Director's reasons for refusing to withdraw or vary a file closure
3 decision that he had made. There is no challenge to the handling of the investigation. The
4 main question which you will have to decide is whether the Director was justified or not in
5 withdrawing the original decision on the basis of the arguments which were put to him by
6 Albion, principally in the s.47 procedure.

7 THE PRESIDENT: Was he justified in not withdrawing it, do you mean?

8 MR. TURNER: In not withdrawing it. I am sorry. Yes – and in the light of all the circumstances.

9 The way I propose deal with the Director's case today is as follows: first, to look at
10 the factual and regulatory context against which the decision was made, and that will involve
11 looking, albeit briefly, at the key documents in sequence so that you, the Tribunal have a clear
12 picture of what happened. Then, to submissions. The first submission will be that two of the
13 main complaints which are made by Albion in the appeal – the margin squeeze complaint and
14 the credit for totality of water introduced complaint – were not advanced, at least at all
15 distinctly, at any time during the s.47 procedure. In other words, Albion did not say, “You
16 should withdraw this file closure decision for one or other of these reasons ----“ Instead, the
17 argument that was raised in relation to giving credit related to surplus water introduced into the
18 system which was beyond the requirements of Albion's customers.

19 In relation to price you have seen the point which is now reflected in Albion's
20 skeleton, which was made in the s.47 procedure, but which is not in the Notice of Appeal,
21 which is that the original 27 pence price must have been abusive because it was eventually
22 reduced owing to OFWAT's intervention – Albion says ‘massively reduced’, 13 pence – and
23 that OFWAT should have gone on in those circumstances to make a finding of infringement
24 against Thames. That was what was said in the s.47 procedure. That is what is said in
25 Albion's skeleton, which, perhaps, you might briefly look at at paras. 13.1 and 13.2. It falls
26 under the heading ‘Albion's Core Submissions’. On p.5, under the sub-heading ‘Abusive
27 Pricing’ Albion sets out its case in summary. At (2) and (3) at the top of p.6, those are the
28 submissions which reflect accurately what was said in the s.47 procedure – that we should
29 have made a formal finding that there was an abuse in the early period, and so on.

30 Now, what is the consequence of the mis-match? Well, the Director's reasons for
31 refusing to re-open the original file closure decision were given in the light of the arguments
32 which were advanced to him at the time. So, the refusal to re-open the matter should not be
33 impugned on the basis of arguments that were not taken in the s.47 procedure. That is going
34 to be the first submission.

1 I am then going to go on to deal anyway with the substance of the points which are
2 argued by Albion. First, I will deal with the claim that access pricing on an average accounting
3 cost basis, which is what Thames did here (charging for the average accounting cost of the
4 distribution assets) involves a margin squeeze in itself, and is contrary to the competition rules.

5 Secondly, I will deal with the related argument that the average accounting cost price
6 is unfair; is excessive unless credit is given against it for the value of the totality of the water
7 which is added to the Thames system – the totality point.

8 Thirdly, I will deal with the argument about surplus – that credit should, in any event,
9 be given for surplus water which Albion injects into the system, surplus to the requirements of
10 its own customers. That is the Overs and Unders point.

11 At the very end, if I may, I will respond briefly to Mr. Thompson’s remarks before
12 lunch yesterday about the submission which is in para. 34 of our skeleton, where we said that
13 the Director does not have a duty to open a detailed investigation into allegations of abuse,
14 such as those which arose in the present case. What was said in those paragraphs is that the
15 Director can say, as he did in relation to Thames’ four month delay, and then in relation to the
16 original 27 pence price, “I’m not happy about those matters, but I’m not going to expend
17 resources trying to reach a definitive, reasoned decision about whether what you did was, or
18 was not, an infringement of the Competition Act”. The Director is entitled to move on.

19 So, that is the route map. If I may, I will turn then directly to the factual and
20 regulatory context against which the Director’s decision has to be considered. It is necessary
21 to understand the context, and there are three relevant matters up front that need to be
22 mentioned. The first is that, as the Tribunal will have seen, a series of what are known as MD
23 letters – letters to Managing Directors – were being put out by OFWAT from 1999 to the
24 industry, effectively, trying to lay the basis for competition in common carriage, among other
25 things.

26 Secondly, Albion was well-versed in those texts, and deployed them in its
27 communications with OFWAT. So, Albion should not be treated as akin to, let us say,
28 A member of the public who is starting from a position of ignorance. They are resourceful
29 business, who are familiar with the workings of the water industry obviously, but also with the
30 regulatory framework which was developing. The OFWAT officials dealt with them on that
31 basis.

32 The third point is that this is a situation in which there were not just written
33 communications back and forth; there were also spoken, informal discussions between officials

1 and Albion’s representatives, and those do need also to be borne in mind when you are
2 considering the adequacy of reasoning, and what the reasons were.

3 Starting then with the MD letters, there were a series that dealt with common carriage,
4 but the ones which I would ask the Tribunal to look at briefly are the ones specifically with
5 issues on access pricing for common carriage as opposed to other aspects of common carriage.
6 Albion has helpfully included the relevant ones (or some of them) in its appeal bundle. So, if
7 the Tribunal would pick up Bundle 2 ---- You will find them collected at Tab 2. The first one,
8 MD 154 is November 1999, and is entitled ‘Development of Common Carriage’. The part of it
9 which we need to look at is quite short on the third page, under the heading ‘3. Principle
10 Elements of Common Carriage’. There is the second full paragraph on the third page begins,

11 “Underlying any common carriage agreement should be a commitment by the
12 incumbent to equal fair treatment of entrants and their customers. I will not expect the
13 incumbent to finance the entry of a competitor into the market, but neither will I allow
14 the incumbent to frustrate entry by setting unreasonable terms for shared use – for
15 example, an incumbent can expect to recover the reasonable costs of operating an
16 essential facility on a non-discriminatory basis, i.e. to treat entrants on the same basis
17 as it treats itself. Equally, the direct costs of entry to the market should be borne by
18 those likely to benefit directly from competition, not spread across the entire customer
19 base. I will not allow common carriage to lead to unsatisfactory levels of service, or
20 jeopardise the incumbent’s ability to finance and carry out their functions”.

21 So, drawing back, what is being said at that early stage is, “There is a key principle
22 that a water company should treat entrants fairly by charging them on the same basis as it treats
23 itself”.

24 Now, the next MD letter dealing with pricing in part was MD 159 which is not
25 copied, but for your note that was February 2000, and it does not contain anything which you
26 need to see.

27 MD 163, which is the next document in the sequence, on p.16 of the bundle is an
28 important one. This is June 2000 now. You will bear in mind as we are looking at these the
29 parallel with the timing of the complaints. It is entitled ‘Pricing Issues for Common Carriage’
30 and the relevant parts of this are, in particular, on p.17 under the heading ‘2. Principles’.

31 “1. The Director has a duty to facilitate effective competition. Consistent with his
32 duty and with the Competition Act companies will be expected to offer access to
33 essentially facilities on reasonable terms”.

1 “2. Each company should charge entrants as it would charge itself and should be able
2 to demonstrate this both to entrants and to the regulator if asked to do so. Companies
3 should also charge different entrants on similar terms for access under similar
4 circumstances.

5 3. Access charges should allow incumbents to recover network operating costs
6 reasonably incurred and capital maintenance charges without over or under
7 recovery.”

8 Pausing there that seems to be setting out principles that are particularly applicable to what
9 happened in our case with average accounting cost pricing for the distribution assets. If you
10 turn over the page, however, under heading “3” there is a section which it might be more
11 sensible for the Tribunal to read to itself, under the heading “Main approaches to access
12 pricing.” What it says is that there are three main approaches – accounting cost basis, the long
13 run marginal cost basis for distribution assets and the efficient component pricing rule. If the
14 Tribunal would briefly read down to heading 4 – “Acceptable pricing conduct” – there is
15 a summary of the three.

16 THE PRESIDENT: (After a pause) Yes.

17 MR. TURNER: You will have read a description of the three approaches; in the last paragraph there
18 there is a comment that the accounting cost approach and charging on the basis of the long run
19 marginal cost of the distribution assets approach are likely to produce lower access prices than
20 ECPR making entry more likely. The comment is that you might bring people in, even if there
21 is a temporary increase in total costs under that approach, but it is a good thing to have
22 competitors in the market because the process of competition, the agitation that might result
23 could lead to dynamic efficiency benefits bringing down prices in the longer run. So that was
24 the thinking at that stage.

25 We then go on to MD170, which you will find at p.25, May 2001. This is dealing
26 specifically with the role of long run marginal costs in the regulation of water services as
27 a general matter. There is nothing of particular interest in the introductory letter, but behind it
28 at p.29 you will find a report, Report A. In the summary you will see that the practical
29 relevance of LRMC relates to a number of issues of importance for water regulation.
30 Competition is one of those, but others include in particular tariff policy, metering, leakage
31 control and a range of other regulatory functions. The importance of it for pricing purposes
32 generally you can see on the following page, p.30 where, under the heading of “Marginal cost”
33 in the second paragraph down, half way down, it says:

1 “The price charged for water at the margin, i.e. the volumetric rate should be, as far as
2 practicable, consistent with marginal costs. Where this is the case customers’
3 decisions to increase or reduce consumption will over the long term, reflect their
4 willingness to finance costs or enjoy savings associated with changes in consumption
5 behaviour.”

6 So from the economic point of view it is a good thing to price for the volumetric element of
7 tariffs at long run marginal cost and that is the basis on which Ofwat approaches pricing for
8 large users. The volumetric element of the tariff they try to reflect as closely as possible to
9 long run marginal cost and you will see that on p.35 under the heading “Large User Tariffs” at
10 the top of the second paragraph.

11 Turning to competition that is dealt with on pages 40 and 41 of the bundle. There is
12 a small introductory section entitled “Competition” on pages 40 and 41 which concludes near
13 the end of the heading “Common Carriage” with the comment that the general customer base
14 should not be expected to subsidise unsustainable price competition for certain customer
15 groups. But we then move on to “Common Carriage” which is the important part, and once
16 again the Director sets out the three possible approaches to pricing for access. First, long run
17 marginal cost on the basis of the marginal cost of the bulk transport and distribution assets.
18 Then in the third paragraph down under that heading “Average accounting cost”, and they say
19 there:

20 “The issue in this case is the appropriate capital valuation to make for the assets being
21 used, in particular the method for allocating the capital value discount at
22 privatisation.”

23 The last approach is the efficient pricing rule in that the large paragraph at the bottom of the
24 page, and they describe that as being based on subtracting the avoidable costs associated with
25 the competitor’s provision of part of the value chain from the retail price, and go on to say:

26 “Where a competitor is providing bulk treated water for common carriage by the
27 incumbent the LRMC of resources and treatment could measure avoidable costs to the
28 incumbent. Using this rule would meant that those companies with a high LRMC for
29 the resources and treatment aspect should have a low charge for access to the
30 distribution network and vice versa.”

31 And then:

32 “In some circumstances it is possible that network access by a competitor might give
33 rise to network cost savings in the distribution side of things which should also be
34 reflected in the terms for network access.”

1 So the basic idea under the ECPR approach is that where costs are avoided that credit is given
2 in the access price charged to a new entrant. So very broadly speaking those were the
3 principles which were in play and were known about by the industry at the time that all of this
4 was taking place. I am going to go on to address Albion's specific points with that in mind
5 later on.

6 We then turn to the key documents which are relevant to the decision that was made
7 in May 2004, and to view them in sequence you will need the defence file, file 3, and they are
8 set out at tab 3. The first document to look at is the original complaint letter itself which is on
9 p.51. (After a pause) The original formal complaint, leaving aside the issue of delay which
10 was made as a complaint slightly earlier was advanced on 7th January 2001. In that letter, up
11 front, there was a complaint about the imposition of an unfair access charge. The access
12 charge had been based on the average accounting cost of the distribution assets. The complaint
13 which was made was not based on any question of deduction for the totality of value of water
14 introduced, or anything of that kind; it was a dispute about whether the price which had been
15 tabled properly reflected the value of the distribution assets being employed – the average
16 value of the distribution assets. The complaint was that the 27 pence price was excessive and
17 not supported by a fair and reasonable allocation of costs, and because they could not see all of
18 the price sensitive information which supported the 27 pence price, they were uncomfortable
19 that it was a fair price. That is the first bullet point, and in the annexe, two pages on, you will
20 see how they worked that through, based on their own very competent analysis.

21 The second bullet point was the complaint about effectively an insufficient discount
22 for the large user water customers. That was the complaint which eventually fed through into
23 a result which led to the reduction of the 13 pence. Over the page is the Overs and Unders
24 point. So, under the heading 'The Imposition of Unfair Trading Conditions',

25 "In relation to demand and supply balancing, Thames has stipulated that in the case of
26 over-provision, where the entrant's customers do not consume their expected demand,
27 but the full amount has been put into the network, no benefit of any over-provision
28 will be recognised".

29 That was the essence of it. There was a request that OFWAT should investigate this complaint.

30 OFWAT then proceeded to do so. Where, however, did the complaint which is now
31 advanced in this appeal about margin squeeze and long-run marginal cost being added to the
32 access price, and then that being higher than the tariff charged at the retail level by Thames ----
33 Where did that come in? That first came in towards the end of September – nine months later
34 – in a letter on p.154. 24 September. This is a letter that Mr. Thompson took you to

1 yesterday. On p.155, at letter 2, above no. 5, the point was made in answer to a question,
2 “Why does this affect you competitively – that if you add the access price the LRMC it is
3 higher than the tariff?” They say the same thing as I believe Mr. Thompson pointed out at the
4 bottom of the page as well.

5 So, for understanding what happened, you see that this is where the complaint comes
6 in, which is now before you. The next development is that OFWAT twists the arm of Thames
7 to breaking point in the language used in the skeleton, and the 27 pence price for large user
8 customers drops to 13 pence at the beginning of January. Mr. Jeffrey of Albion calls OFWAT
9 at that time. The document is at p.178. He speaks to Mr. Dixon. This is the note in which it is
10 recorded that he rings to say a big ‘Thank You’ for the reduction. It goes on to say,

11 “He said on balance the price looked good, but he was concerned about the
12 supplementary fixed charge which equates to the fixed charge paid by Thames’ large
13 users. Mr. Jeffery was concerned to avoid double-dipping. To what extent did this
14 fixed charge cover resource and treatment costs which Albion would not impose on
15 Thames?”

16 Then, further down, in fairness, towards the end of that paragraph,

17 “Mr. Jeffery also noted that Albion had complained about the standard price, 27
18 pence, and that this had not changed. I said this was broadly right. Mr. Jeffery said
19 that the price was the biggest of the hurdles which now looked to have been
20 overcome, but asked how many other issues OFWAT was still considering, and so
21 on”.

22 So, this is a letter in which at least Albion communicates some satisfaction on the
23 price, but expresses a specific concern about one element which is the supplementary fixed
24 charge.

25 The next development is the provisional file closure letter at p.187 which I do not
26 suggest we read through. You will be well-familiar with that. That contains the list of reasons
27 under the headings for complaints. It was sent to Albion for comment – as it were, as a draft.
28 Albion’s response to that is on p.191, and was on 21 March. It is an important letter in the
29 present context. Mr. Jeffery begins by saying that, “Substantial progress has been made in
30 addressing our concerns”, which must be right, and that it would be helpful to meet with Beryl
31 Brown to see whether our remaining concerns can be addressed outside of the formal
32 complaints process”. He then comments on each of the complaints, one after the other. On the
33 excessive price issue he says that he is not happy that the production of the large user tariff
34 alone is justification, but the reason he gives is, “Our assessment was significantly lower”.

1 What had happened was that Albion, on its own view of the fair allocation of the assets had
2 come up with a figure of, I believe, 23.6 pence, or something of that order, and they believed
3 that that was the fair price. But, he says, “However, I would be happy to accept that no further
4 work is justified if you are able to confirm you have checked the Thames Water proposals
5 against, and found them to be consistent with, the requirements of the latest June return data
6 and the regulatory accounting guidelines”.

7 Turning over the page, very briefly, under the large user heading, he says he is still
8 not happy because he wants the question of the supplementary fixed charge to be looked at in
9 essence, and he wants an explanation about what it is based on.

10 Complaint 3 is the price-sensitive nature of some of the elements so that they had not
11 been able to do a full audit of the figures themselves, but he says at the end, “I will be happy
12 for the file to be closed on this complaint following the reassurance sought in relation to
13 Complaint 1 above”.

14 Complaint 4 is explicitly, again, Overs and Unders. You will see how it is put – not
15 as totality. Thames will not provide an equivalent credit for over-supply. He says that it ought
16 to be symmetrical. Now, at first sight, one might think that that means that if Thames is
17 charging the retail price in the case of under-supply, that for symmetry, what they are saying is
18 that there should be a credit at the full retail price, given to Albion whenever they put surplus
19 water into the system because that would be symmetrical. That turned out to be the basis on
20 which at least Thames understood the issue.

21 THE PRESIDENT: Have you taken us to the Access Code Guidance that is being referred to there?

22 MR. TURNER: I have not taken you to it. I will take you to it if you would like to see it now.

23 THE PRESIDENT: I think we might just get that. It is probably part of the context, is it not?

24 MR. TURNER: It is in Bundle 4, I think – the Thames Statement of Intervention bundle. That is at
25 Tab 5. You need to go to pages 31 and 32. The heading is ‘Metering and Flow Balancing’.

26 “OFWAT expects companies and entrants to agree how to balance water flows over time, and
27 the method of charging reimbursement for over or under-supply to be fair and transparent”.

28 Then, if you turn to p.32 ----

29 THE PRESIDENT: This document, which is dated March 2002, looks as if it had only just come out
30 when Mr. Jeffery wrote his letter of 21 March.

31 MR. TURNER: Yes. I will explain that, because I want to explain why he uses the word
32 ‘symmetrical’ which you will not see here.

33 THE PRESIDENT: No. Quite.

1 MR. TURNER: If you just read what is said on p.32, the key point is that there should be a fair and
2 transparent method of charging or reimbursement. It is mainly dealt with in the last full
3 paragraph above 2.3.6 on the following page. You will see that concludes by saying,

4 “Where there is a significant breach of agreed inputs, the company will have to assess
5 whether that was costly – for which it might charge the entrant – or beneficial – where
6 it might reimburse the entrant. In either case, the company must be transparent and
7 fair in how it calculates the value of cost or benefit”.

8 Now, Mr. Jeffery, as you pointed out, sir, refers to a different quote in relation to para.
9 2.3.5 where the method of charging reimbursement should be symmetrical. You will not find
10 that there. The reason is that he was referring to a draft which was superseded by the actual
11 guidance put out here. There is a reference to the change in the language of the draft in the tab
12 you are looking at now, towards the back, at p.23. It is p.23 of a separate document which
13 includes discussion of responses on the draft. At p.23 under 2.3.5 the bottom paragraph ---- In
14 fact, all of it is quite relevant, but the bottom paragraph says that it seems that

15 “Entrant and company should communicate and co-operate over balancing. It seems
16 sensible for the parties to agree a range of volumes within which the entrant can vary
17 its inputs without the company or the entrant incurring any extra costs. The range can
18 be reviewed regularly, and if the entrant is consistently outside that range, then it
19 would have to adjust its inputs for its customers’ demands, or change the agreed
20 range. Where there is a significant breach of agreed inputs the company will have to
21 assess whether that was costly, for which it might charge, or beneficial, where it might
22 reimburse the entrant.”

23 Then, in the last sentence, “Our request for symmetry [which was something that had been said
24 in the draft] relates to the method by which this calculation is made. We have added these
25 points to our guidance”. So, I think the point is that whereas the draft had been ambiguous
26 about whether actual symmetry as to the result was required. The final guidance, and the
27 consultation response, is making clear that you have to be symmetrical in relation to the
28 method by which the calculation is made.

29 THE PRESIDENT: But, the underlying principle is that if there is a benefit you get a credit, and if
30 there is cost, you get a charge.

31 MR. TURNER: Yes.

32 THE PRESIDENT: So, it is a question of fact presumably as to whether it is a benefit or a cost.

33 MR. TURNER: Yes, it is a question of fact.

1 PROFESSOR PICKERING: Sir, this symmetry ---- Page 23 of the discussion document is actually
2 confirming the desire for symmetry in the method ----

3 MR. TURNER: Yes.

4 PROFESSOR PICKERING: But in the published document the concept of symmetry does not
5 actually reappear, does it?

6 MR. TURNER: No. What they have said is that it should be fair and transparent, but what they
7 mean is that the same approach should be used – you should not be inconsistent.

8 PROFESSOR PICKERING: Fair and transparent does not seem to me necessarily to imply any
9 sense of symmetry.

10 MR. TURNER: It is because different considerations may apply. I will jump to the chase because in
11 this case if there is an under-supply Thames ends up simply supplying the customer itself from
12 its own resources, and it charges a price for that. However, in a case of under supply, which is
13 the issue in this case, it may not be the case that Thames receives an equivalent benefit equal to
14 the price, but as a negative figure. The reason is that for much of the time Thames is not in
15 a state of crisis as to its water resources, it has a surplus so that the effect of injecting some
16 extra water in is simply to back up storage capacities at the reservoirs and so on, to use the
17 system a little bit more, but it does not confer an equivalent in real commercial economic terms
18 on Thames. That is why, although at first sight you might say it should be an equivalent
19 amount one way and the other, the considerations are different in practice. That is the
20 argument which I will be coming to ----

21 THE PRESIDENT: We are a bit hazy at the moment, Mr. Turner, we would like a bit of help as to
22 what the surplus deficit position is because we are being told, or I got the general impression
23 that there is a deficit problem of some kind in London, at least in East London, and that part of
24 Albion’s argument is that it is in general beneficial to be putting more water into the system.
25 One would have imagined that even if this water comes in at times when Thames does not
26 actually need it, at least in theory it is available for storage – water does not disappear, it is
27 available in theory for later time periods when there is a shortage.

28 MR. TURNER: It is not in fact factually correct – and I will show you some of the evidence on that
29 – that Thames is in a permanent state across its entire area of water shortage. It gets into
30 a state of particular crisis periodically every number of years, typically. But for much of the
31 time it has the water it needs.

32 THE PRESIDENT: And we gathered it was thinking of building a huge new ----

33 MR. TURNER: Desalination point.

34 THE PRESIDENT: -- structure for some reason to deal with the problem.

1 MR. TURNER: Yes, that is also correct. As a general matter it is building a large desalination plant,
2 I am not sure whether it currently has the planning permission or not, but this is because the
3 margin between its available resources for water and growing customer demand is, in general
4 unacceptably small and that is a recognised problem. The fact is, however, that it bites as
5 a problem only periodically on sustained very hot periods and so on, and for much of the time
6 Thames does not need additional water injected in. There is a separate question which I will
7 also come to in considering overs and unders which relates to the location of the injection
8 within the network and control over it. You will have seen reference in the papers to it being
9 more efficient to be able to bring on the resource at particular times rather than simply to have
10 water flooding in constantly in parts of the system. So all of those are factual issues, but the
11 general point is that there is an overall shortage in terms of the margin of security which
12 customers have and that is the reason for the building of the desalination plant if it goes ahead.

13 PROFESSOR PICKERING: Can I just ask, in terms of understanding a system operation, or
14 a network, when the desalination plant is up and running, will that just be used to meet the
15 deficiency at the margin or will that become in some sense a base load provider of water?

16 MR. TURNER: I am not myself knowledgeable as to how it is going to be operated, Mr. Tupper will
17 probably ----

18 PROFESSOR PICKERING: Perhaps he will address us in due course. Thank you.

19 MR. TURNER: So where we were was looking at the letter of 21st March and the position that
20 Albion had taken on the complaints. The one on the final page relates to delay in providing an
21 indicative access price originally and we are not, I think, concerned with that. The next
22 relevant place to go is the period immediately after the closure of the file, at the beginning of
23 April, and there was a note of a telephone conversation between Miss Cooper of Ofwat, and
24 Mr. Jeffrey on 5th April, which is at p.197. The conversation took place the previous day on
25 4th April, and this is the note of it. Once again, Mr. Jeffrey called about the Bath House closure
26 letter. He was concerned that there may still be some letters outstanding relating to the
27 complaint but which are not specifically CA 98 complaint issues, and he wanted to discuss and
28 so on. He wanted comfort that we had looked at the issues that he had felt important.

29 The next paragraph is the issue which we have dealt with in writing relating to the
30 appreciation of Ofwat about whether it has made an appealable decision. Unless the Tribunal
31 wants the only point I will add to what we have said in the skeleton is to draw your attention to
32 the date. This conversation took place on 4th April. The *Bettercare* Judgment had been
33 delivered on 26th March that year, about a week beforehand, there were still discussions about

1 the implications of it. The issue was whether it required a final definitive decision to have
2 been made or not.

3 Turning to the complaints. Complaint 1, which was excessive price, Mr. Jeffrey
4 wanted comfort that we had looked at the price that Thames had offered it. Miss Cooper
5 explained that it was not appropriate for us to determine the price. However we had reviewed
6 the price against information we had available and were content that the methodology was
7 consistent with the methodology that Thames applied in calculating its tariffs.

8 THE PRESIDENT: This is the 13.6 price?

9 MR. TURNER: Yes, it is and, insofar as it does not apply to large users it will still be the 27p
10 because that has not changed. But the idea is that they have looked at the numbers. They have
11 not done a full audit, but they have checked the methodology is consistent, and this is a follow
12 through from what Mr. Jeffrey had said in the letter of 21st March. Complaint 3 is the parallel
13 complaint about the price sensitivity of the figures which was not discussed. Complaint 2 was
14 the issue about the standing charge on the 13p for large users, and Miss Cooper said that the
15 standing charge was consistent with the way Thames applied its tariffs. “We were looking for
16 a consistent approach and MJ accepted this.”

17 Complaint 4, very briefly is again overs and unders, and a discussion appears to have
18 taken place between them about the merits and demerits of giving credit for over supply for
19 surplus water into the system, and you will see what is said there – essentially the most
20 relevant paragraph is the one beginning “MJ appreciated that access code guidance allowed
21 some leeway on this issue”.

22 “Although the approach to pricing for over and under supply ideally should be
23 symmetrical MJ took the point that there was a cost to the incumbent associated with
24 over supply from an entrant.”

25 He agreed that the volume of the source being used by an entrant would be relevant.

26 “A large reliable source would be of benefit to the incumbent and might offset the
27 cost of balancing over supply, but a small sporadically available source would be of
28 little value to the incumbent.”

29 That, I think is all I need to look at from that conversation.

30 THE PRESIDENT: I am just running my eye down the rest of the conversation about the over and
31 under supply. “Reliability of the source”, “Thames has got its network to balance”.

32 MR. TURNER: Yes, one point that I think the Tribunal might need to bear in mind, it was not
33 obvious to me either, originally is that whereas you charge an access price for carrying the
34 water to Albion’s customers, when you are talking about water above and beyond that, surplus

1 water, you are not, as it were, asking them to carry the water through their system to customers
2 of yours, you are delivering water to them as a form of making available a resource and so
3 there is not necessarily an access charge that is going to be levied in respect of the surplus
4 water at all. What there needs to be is a discussion about the value of that additional resource
5 from Thames's perspective which is being made available to it.

6 THE PRESIDENT: Yes. As far as I can see what he is saying is that sources like this tend to run on
7 the basis where the pumping is constant, but because customer requirements vary there will
8 tend to be surpluses from time to time. If you get nothing back for that that is going to be
9 a further hurdle for new entrants of this sort.

10 MR. TURNER: Yes, there are two responses to that. First, as a matter of fact – and I will show you
11 some evidence – it is not actually correct that, for example, Thames just runs its own boreholes
12 at a constant rate. It brings on resources when there is need in the system, or at least that is the
13 evidence. Secondly, you need to bear in mind also the point about the supply envelope that
14 there is a reconciliation over a period, and what Thames was saying that provided you stay
15 within a margin of tolerance either side that will do. Mr. Jeffrey was making the point that
16 from his perspective it is most efficient to run the thing flat out all the time.

17 THE PRESIDENT: Yes.

18 MR. TURNER: That concludes effectively the file closure decision part of the case, and the reasons
19 given to Albion for having made it. You now enter the s.47 procedure in which Albion asks
20 Ofwat to withdraw or vary its decision on any grounds where it remains dissatisfied, and the
21 first document which you now need to view is on p.206, which is the first s.47 letter. This
22 relates exclusively to the overs and unders point, and you will see at the very bottom of the
23 first page:

24 “One aspect of the complaint is of such significance that I feel it necessary to proceed
25 further. That element is the intention of Thames to charge for under supply where
26 customers' demands are not met over the balancing period (to be specified) but will
27 not provide an equivalent credit for over supply”.

28 Once again, the reference to “equivalent” might be taken to suggest essentially a credit at the
29 retail tariff level. You will have read this letter so I do not need to go through it in detail. In
30 fairness, on p.208 I will take you to the two points that were made by Albion to attack the file
31 closure decision. They say: “I therefore find it difficult to accept you conclusions on this
32 complaint.” Then under two bullet points they set out the thrust of what they are saying. The
33 first is well of course they get a significant benefit from the over supply, look at its short run
34 avoidable costs relating to resource and treatment, its long run average incremental cost of

1 deferring expenditure, and its long run marginal cost. So what they are saying is it saves all
2 this money because it does not have to produce the same water itself, and we should get the
3 credit for that. They also say that in relation to balancing and buffering what is the evidence
4 that there are costs imposed on the system when you put surplus water into it? I would like to
5 see that, and where it falls. You will see just underneath that they now quote the final version
6 of the access code guidance with the reference to fair and transparent.

7 So that was the first letter. The next development at p.218 is that Ofwat publish the
8 decision that they had made closing the file the year beforehand.

9 THE PRESIDENT: So wait a minute, this is the letter of 6 August, 2002.

10 MR. TURNER: Yes.

11 THE PRESIDENT: Nothing then happens; is that right?

12 MR. TURNER: Nothing then happens. You will have seen from the letters that Mr. Thompson took
13 you to yesterday that some of the delay was accounted for by a confusion about whether they
14 had made a decision ----

15 THE PRESIDENT: -- to which s.47 would apply.

16 MR. TURNER: -- to which s.47 would apply. At any rate, there is a gap. They publish. They
17 decide that they have done so in March 2003, and because they have done so there is an
18 obligation to publish the thing. They publish it, and the document is at p.218. What you see on
19 p.219 – because there is only one part of this I want to show you – is OFWAT’s understanding
20 of what was meant by intermittent and unpredictable surpluses, because what was said was
21 said was that we were under a factual misapprehension that the borehole would just have water
22 pumped out at fluctuating rates. But, in fact, that was not a factual misapprehension. If you
23 look at the second full paragraph on p.219, the point is explained. “

24 “It is not always possible to input a constant volume of water from boreholes. There
25 are interruptions. Even if Enviro-Logic could input a constant volume of water from
26 the boreholes into Thames Water’s network, the demands of Enviro-Logic’s
27 customers might vary from time to time”.

28 Then there is a discussion of how you deal with over-supplies and under-supplies by using
29 a balancing system. The question of whether there is an over or under-supply is usually
30 assessed over a balancing period.

31 THE PRESIDENT: Do we know how long a balancing period tends to be?

32 MR. TURNER: A month was regarded as reasonable in this case. The reconciliation takes place
33 over a month.

34 THE PRESIDENT: Yes.

1 MR. TURNER: That is then followed a month later – just under a month later – by a second s.47
2 letter which is on p.246. In this letter, apart from the overs and unders issue, reasons are given
3 for why the Director should vary or withdraw the original file closure decision on the other
4 heads of complaint. Again, you will have read this letter, but if you take Complaint 1 ----

5 THE PRESIDENT: I think Mrs. Brown came back and said, “There are various bits you have not
6 done”; is that not right? “There are various things you have not done”?

7 MR. TURNER: What she said they had not done was give reasons for why they wanted the file
8 closure decision varied or withdrawn.

9 THE PRESIDENT: Right.

10 MR. TURNER: This is the letter in which they say, “All right. Well, here are our reasons”.

11 Complaint 1 – which was the excessive price complaint.

12 “On investigation, OFWAT agreed and made representations to Thames about its
13 approach. Thames subsequently revised its price. In effect it revised its price from 27
14 pence for water input to serve all customers, including large users, to one of 27 pence
15 for water serving non-large users. This represents a measurable reduction. It took
16 over a year to receive the revised price from the date of our complaint, during which
17 time my company was prevented from competing with Thames in the relevant market.
18 In the light of these facts, I believe the decision that the Chapter II prohibition had not
19 been infringed is incorrect from the point of view of ----“

20 And then the reasons are set out, but essentially the main one is,

21 “The offer of the revised price confirms that an excessive price had been offered. The
22 facts and analysis relied on in the second bullet point, which goes back to February
23 2001 are the average accounting cost considerations which were in play at that time”.

24 So, the thrust of the complaint on price, “You have made a non-infringement decision.
25 That must be wrong because the price was revised downwards. In a sense, it is perverse for
26 you to have found that there was a non-infringement decision given those facts”.

27 The following elements of the s.47 letter follow the same pattern. Essentially the
28 conceptual basis of what is being said is, “You have effectively made, or should be treated as
29 having made, a decision that there was not an infringement of the Competition Act. That must
30 be wrong because of what happened”. If you look at p. 248, just under Complaint 4, for
31 example, about three paragraphs up from the bottom,

32 “In support of my application, I draw attention to the lack of consistency between the
33 OFWAT letters to the complainant and to the incumbent. It is clear from the letter to
34 Thames that OFWAT believe that Thames had acted wrongly, and from the letter to

1 Enviro-Logic that it did not wish to take any further action. I believe this must have
2 given Thames some comfort that they could act in the way that they did, and escape
3 any consequences”.

4 So, the real complaint is, “You have effectively made a non-infringement decision. Thames
5 are getting away with it. It is wrong”.

6 That concludes the complaints that were made in the s.47 procedure. What you then
7 have is a follow-up on those complaints by the Director. He writes to Thames by letter on
8 p.258 of the file in January 2004. On the second page of that letter he asks a number of
9 questions relating to both the overs and unders issue, and the issues of price and other things
10 that have been raised by Albion. So, on p.259 you have a series of questions which all, in my
11 submission fairly, pick up on the points that had been made by Albion in the two s.47 letters,
12 and asked Thames to explain itself.

13 THE PRESIDENT: This has gone from the second s.47 letter, which was April 2003, and this is
14 now being picked up again in January 2004; is that right?

15 MR. TURNER: Yes. I cannot get away from the gap in time. So far as the questions are concerned,
16 I would invite the Tribunal just to cast an eye over what was being asked.

17 THE PRESIDENT: Yes.

18 MR. TURNER: Essentially, the first three questions are concerned with the overs and unders point,
19 culminating in the question about whether, and if so for how long, Enviro-Logic continued to
20 discuss its common carriage proposals with Thames after Thames had said in the letter I think
21 we saw yesterday, “We would be happy to discuss paying them for a surplus if they had
22 a reliable and continuous surplus, but they have not come back to us”.

23 Then, in the last three questions, they are concerned with the issue of price because
24 what had been said by Albion, you will recall, is that, “In view of the issues about the data that
25 was used to arrive at the average accounting cost-based price, we still have concerns”. Points
26 referred to by Mr. Jeffery in his letter of 1 February, 2001. Permission is asked for to show
27 information to Enviro-Logic to enable it to gain a better understanding of the make-up of the
28 price, and so on.

29 The response from Thames, which is important, is at p.261, focusing on overs and
30 unders. In paragraph 1, the second paragraph down, “As you would expect, Thames has an
31 established process for new water resources development, summarised in Annexe 1”, and then
32 that is explained. “This is primarily determined through considerations of need as determined
33 by the supply/demand balance, the likely cost versus benefits, business risk, and so on.” If you
34 look at Annexe 1 on p.265, you will see there in the first big box, ‘Asset Planning Investigation

1 Proposal'. The technical issues enumerated include matters such as the location of the source
2 – because it does matter (this is their internal document) – need case for water; catchment
3 impact; and growth planning as well as yield, water quality and other factors.

4 So, in terms of Thames deciding for itself whether it gets a benefit from an additional
5 supply of water, those are all factors which, internally, it looks at.

6 Turning the page is the part that I read to you yesterday afternoon about the viability
7 of these particular boreholes. Under Point 2 on p.262 they say at the bottom, “We have always
8 sought to be flexible in our approach to new entrants, and if it had been suggested at the time
9 we would have been happy to consider Thames matching the demand profiles of Enviro-
10 Logic’s customers and carrying out necessary balancing and buffering as if it were our own
11 ground water source”. Then, over the page,

12 “This is precisely why we continued to state, as per our July 2002 letter, that if
13 Enviro-Logic had a reliable continuous surplus of water, we would be happy to enter
14 into discussions with a view to possibly purchasing the surplus. No response was
15 forthcoming, which further served to suggest that Enviro-Logic were not actually
16 intending to commission the supply in any event”.

17 Then, in 3 there is a reference to how they general discussions relating to the potential
18 for Thames to acquire the ground water sources. That is now dealt with in Mr. Shaw’s witness
19 statement.

20 Last but one, p.271 is a note of an internal analysis conducted by OFWAT comparing
21 the regulatory data that they had with the elements of the access price that Thames had built
22 up. The conclusion on p.273 is at the very end. “From the investigation I have done with other
23 colleagues in OFWAT we are satisfied that Thames’ calculation of the access price is
24 consistent with the regulatory accounting guidelines in the June return data which were
25 available to OFWAT when we were investigating the complaint”. So, in other words, they
26 have now not just looked at the methodology for consistency; they have looked at the numbers
27 as well.

28 Then, finally, you get the letter which is effectively the subject of this appeal – 1
29 April, 2004 on p.274. In relation to price OFWAT records at the bottom of p.275, “In
30 assessing the consistency of the proposed access price with the regulatory return information
31 available to OFWAT at that time, OFWAT has had sight of all relevant information, including
32 the relevant price-sensitive information”. It refers to the point that had been made by Albion
33 above – that they would be happy to accept that no further work is justified if that confirmation
34 is given. Under Complaint 2 there is a reference to the fact that Enviro-Logic appears to

1 believe erroneously that OFWAT has taken the decision that the Chapter II prohibition was not
2 infringed. Mr. Thompson mentioned this yesterday.

3 Now, the argument appears to have been that OFWAT should have proceeded to
4 make an infringement decision after having forced Thames to drop its price to 13 pence for
5 large users. OFWAT's essential response here is that it was entitled to prioritise its resources
6 and not to investigate the matter further. At that time they said, "It follows from that
7 characterisation that we have not made a definitive non-infringement or infringement decision,
8 and so we don't regard this as a s.47 decision at all for the purpose of the procedure". I will
9 clarify again – this is not a point that I am taking in this appeal, but that is what they said at the
10 time.

11 THE PRESIDENT: I am assuming, Mr. Turner, that our jurisdiction is taken as read at the moment.

12 We do not have to go back into admissibility issues.

13 MR. TURNER: I am not going back into that.

14 Complaint 4 – Overs and Unders. Pages 276 and 277. The essential point on p.277,
15 in the middle of the page, and referring to the letter from Thames of 21 September, 2001, is the
16 point about surplus water likely to be available when least needed, and the hydraulic
17 management of the system being hindered by water being injected into the system when not
18 required. In other words, Thames' point that Albion is wrong to think that Thames is in
19 a permanent state of general shortage for water, with the result that any surplus injected into its
20 system at any time must be of value and should be paid for by Thames. As I say, I will come
21 back to the substance of this directly, in a moment.

22 The other point that is made just below that is that Thames had always said it would
23 discuss terms to purchase any reliable surplus from Albion above the supply envelope needed
24 for servicing Albion's customers.

25 We do not need to look at the question of initial delay, which is Complaint 5. That
26 concludes the survey of the key texts in the case.

27 I move to submissions. The first submission is then that the allegations of margin
28 squeeze and credit for the totality of water introduced were not points raised in the s.47
29 procedure. We make this point at the forefront of our defence. You find it in paras. 8 to 10 of
30 the defence for margin squeeze, and paras. 12 to 13 of the defence in relation to totality. You
31 cannot find those complaints anywhere in the s.47 procedure. Because Albion did not raise
32 those matters then, it is hardly surprising that they were not addressed in the letter from
33 OFWAT giving reasons in April 2004.

1 The issue of compliance with the s.47 procedure was one of the matters which the
2 Tribunal raised of its own motion at the case management conference in February. Now,
3 Albion responds to that in its reply, and it says, “It would not be appropriate to apply a rigid
4 legal test, among other things because Albion is a small company and because it was not
5 represented in relation to this matter until the commencement of these proceedings”. That is in
6 para. 6(e) of its reply. I do not ask you to turn that up now, but our response is this: Albion
7 certainly knew all about the s.47 procedure. There cannot be any doubt about that. It had
8 actually retained Eversheds, as the Tribunal will know, on the Shotton case, which was running
9 at the same time in 2001 and 2002.

10 THE PRESIDENT: Albion is still Enviro-Logic at this point, is it?

11 MR. TURNER: It is, yes. It is the same individuals.

12 So far as the substance of the complaints are concerned, that is a matter for the
13 businessmen. Albion can be assumed to know itself what are the commercially important
14 reasons for arguing that a file closure decision should be re-opened. So, it is appropriate for
15 you to look at the reasons that it did actually advance. The failure to comply with the s.47
16 procedure means that the appeal on either new grounds or old grounds which were not
17 re-visited after March 2002, depending on how you wish to approach it, should not succeed. It
18 would be unreasonable to expect Ofwat to deal with matters which were not raised with Albion
19 at the time. That is the first submission.

20 THE PRESIDENT: Have we not got some authority on this, Mr. Turner, somewhere?

21 MR. TURNER: On which particular question?

22 THE PRESIDENT: On the question of whether you can make a new case in an appeal over and
23 above the case that you have been making during the administrative procedure? I know you
24 can if you are an appellant appealing against an infringement decision, but I have a feeling that
25 somewhere we have said that it is the original complaint that sets the framework for the appeal
26 in a non-infringement.

27 MR. TURNER: That is the first *Freeserve* case, and the argument there, Sir, as you and Professor
28 Pickering will remember is that the points raised were outside – in Oftel’s submission – the
29 administrative procedure completely, and to some extent that was accepted, but in any event
30 the Tribunal found in its judgment that the complaint does set the parameters within which the
31 Decision has to be assessed.

32 THE PRESIDENT: And this is the same sort of point, is it not?

33 MR. TURNER: It is the same sort of point. I accept that margin squeeze was a point raised before
34 March 2002. What I am saying here is that neither margin squeeze, nor the question of totality

1 were ever raised in the s.47 procedure and totality was not raised at all throughout the entire
2 case. The Appeal under s.47(6) of the Act is against the refusal to vary or withdraw the file
3 closure. That constitutes the jurisdiction of the Tribunal and so it is appropriate to focus on the
4 s.47 procedure in the circumstances which have arisen in this case.

5 THE PRESIDENT: Yes.

6 MR. TURNER: That is the first submission. I then turn to the substance, the price issues first. The
7 Chapter II prohibition prohibits dominant undertakings from imposing unfair selling prices
8 (s.18(2)(a) matching Article 82 of the Treaty). Essentially, Albion's complaint about access
9 pricing on the basis of the average accounting cost methodology, which was used here, is that
10 it is therefore an unfair selling price for the purpose of the Chapter II prohibition. One variety
11 of unfair price can be a margin squeeze. Although Mr. Thompson kindly used counsel's
12 submission as a definition for margin squeeze, perhaps the most helpful relevant definition,
13 given that this is a utility industry, might be that used in the Commission's telecom's notice,
14 which is in the bundle at bundle 7, tab 9. Tab 9 you need to go to paras.117 and 118 in the
15 Notice under the heading "Price Squeeze". It is fair to say that I do not think any of this is
16 controversial, but this is a handy definition.

17 "Where the operator is dominant in the product or services market, a price squeeze
18 could constitute an abuse. Price squeeze could be demonstrated by showing that the
19 dominant company's own downstream operations could not trade profitably on the
20 basis of the upstream price charged to its competitors, by the upstream operating arm
21 of the dominant company."

22 That is the first approach. Paragraph 118 refers to another approach in appropriate
23 circumstances, which is where you look to see whether the charges made are insufficient to
24 allow a reasonably efficient service provider to obtain a normal profit? I would ask you
25 particularly to bear in mind the definition in para.117 whether the dominant company's own
26 downstream operation could not trade profitably, and to turn over the page to para.128 where
27 there is simply a reminder that there can be objective justifications as well for particular
28 behaviour and that justifications could include factors relating to the actual operation of the
29 network owned by the access provider – among other things.

30 THE PRESIDENT: Yes, we were looking at another case last week in which a relevant regulator,
31 not here present, was preferring the para.118 approach to the para.117 approach.

32 MR. TURNER: From my point of view it does not particularly matter.

33 THE PRESIDENT: So nothing turns on that, thank goodness.

1 MR. TURNER: Not really. Were they preferring it in the sense of saying that the para.117 approach
2 is wrong, or simply that it was applicable in those circumstances.

3 THE PRESIDENT: I cannot remember, Mr. Turner, and even if I could I am not sure that I would
4 be able to say.

5 MR. TURNER: Albion is raising a margin squeeze complaint which, as I say, was not part of the
6 s.47 procedure. Its essential complaint in competition terms is set out in the Notice of Appeal
7 at para.2. The basic idea, as you see from the last paragraph of the introductory section of their
8 case is that Thames Water's customers are going to end up paying more for their water in
9 future than would have been the case had more efficient competitors, such as notionally
10 Albion, provided the extra water which is needed. The margin squeeze complaint is then
11 developed throughout the document and at other places including para.41. What Albion does,
12 as you know, is to take Thames long run marginal cost figure at the time for resource and
13 treatment, which relates to the entire London area, of 45p per cubic metre as indicative of the
14 cost to Thames to supply the customer instead of Albion.

15 Our submission is that the proposition that Thames's customers would have to pay
16 more for their water because of the use, as here, of the average accounting cost methodology to
17 set the access price is wrong in three crucial respects. First, the methodology does not close
18 the door to competition, which is the assumption.

19 THE PRESIDENT: Is the methodology to arrive at the 27p?

20 MR. TURNER: Yes, or the 13p as it was revised. In either case, what Thames have done is they
21 have taken the average cost of using the distribution assets for carrying water in their system,
22 and there is no distance related element, it is just an average figure, and it relates to everything
23 that they need to do to carry the water to the customer.

24 My first point is that it does not close the door to competition to price on that basis.
25 You will recall in passing from MD163 the comment that this was likely to be quite an
26 effective way of allowing competitors into the market, at least compared with the two other
27 approaches, which were then envisaged in that letter, and that bringing competitors in on the
28 thinking at the time could bring benefits. The point is that where Albion's (or a new entrant's)
29 specific costs of resource and treatment are lower than Thames's average costs, it can enter the
30 market. What you need to remember is that the retail tariff is built up by adding the average
31 accounting costs of the distribution assets with a reasonable return, to the average accounting
32 costs of the resource and treatment assets plus a reasonable return. That is how it is arrived at.
33 If Albion are being charged a cost equivalent to the average cost of the distribution assets they
34 are faced with a margin which broadly equates to Thames's average costs for the resource and

1 treatment. The thinking behind the average accounting cost approach conceptually is that
2 wherever the new entrant can enter with its specific costs of resource and treatment being
3 lower than Thames's average costs it is free to do so. So it is not market closing approach to
4 use a crude expression. That is not to say that the average accounting cost methodology does
5 not have very rough edges. It does, and one of them, which I believe Mr. Anderson touched on
6 in the Shotton case, is that Albion's specific cost of resource and treatment, of getting the
7 water could be higher than Thames in a particular case, but still lower than Thames's averaged
8 regional costs, which are the ones used in the average accounting cost calculation. That means
9 that in areas where the specific costs (the local costs) of resource and treatment are low,
10 compared to the average, potential entrants, such as Albion in this case, can come in. They can
11 even come in if they are more inefficient than Thames. So not only is it not a systematic
12 market closing price, in some circumstances it even allows inefficient entry.

13 The second point is this, so far as the interests of customers are concerned ----

14 THE PRESIDENT: You will have to bear with us, Mr. Tupper, for a moment, but I thought that we
15 were being told that in Shotton that you should not look at local costs and that even the local
16 entrant with possibly lower costs locally should have to bear, even on average accounting
17 principles, some over general share of the overall cost of the system, regionally speaking.

18 MR. TURNER: On the average accounting cost basis that is what happens. They are charged on the
19 basis of the average cost of distribution. I will come on to the way of charging which relates to
20 specific costs avoided, which is the efficient pricing rule.

21 THE PRESIDENT: Yes, but just staying with the average costs for a minute, what was being said in
22 Shotton was that you just cannot come along with low local costs and expect to put water into
23 the system and undercut the local supplier because the local supplier is carrying the general
24 overhead charge of the distribution costs for his system, regionally speaking.

25 MR. TURNER: Yes.

26 THE PRESIDENT: Just a moment, Mr. Turner. (After a pause) Carry on, Mr. Turner, forgive me.

27 MR. TURNER: Under the average accounting cost approach it is the case that someone who does
28 have lower costs than the average can come in on access pricing which uses that approach. We
29 are digressing to an extent, but Mr. Anderson in fact addressed this very point on day 3 of the
30 transcript at p.32.

31 THE PRESIDENT: I think, Mr. Turner, before we go too far I would like to rise for a moment and
32 deal with that interruption I had a moment ago.

33 MR. TURNER: Yes, of course.

34 THE PRESIDENT: We will rise for five minutes and pick up the thread in a moment.

1 (Short break)

2 THE PRESIDENT: Yes.

3 MR. TURNER: Sir, as I understand it the question is whether ----

4 THE PRESIDENT: Well you were telling me that a low cost local entrant could enter if he had
5 a cost advantage ----

6 MR. TURNER: On resource and treatment.

7 THE PRESIDENT: And I was remembering – or thought I had remembered – that in Shotton we
8 had been told that we should not really be thinking about local costs, but that everybody should
9 bear their share of the regional costs being incurred by the incumbent.

10 MR. TURNER: Yes, I believe that the difference is that in that case the argument might have been
11 about the distribution costs, because in a case where ----

12 THE PRESIDENT: Yes, it is about the distribution costs.

13 MR. TURNER: And here we are talking about resource and treatment.

14 THE PRESIDENT: Right.

15 MR. TURNER: In a case where somebody can come along and say “What are the local costs of
16 distributing the water here, and that should be the amount of the access price charged to me?”
17 you will find very quickly that in the areas of low distribution cost, new entrants coming in and
18 taking the business and the basis for the averaging, which forms the basis internally for the
19 social policy of uniform tariffs becomes unravelled. Here what we are saying is that under the
20 average accounting cost methodology which is one of the three approaches used, and which
21 was used in this case, the new entrant is charged for the carriage of the water for distribution,
22 an average cost representing the average cost of the distribution assets used by Thames for
23 carrying water, and it does not have a distance component. Everybody pays the same charge.
24 But that leaves on top of the access charge an element between that and the retail tariff. That
25 difference amounts to Thames’s own average cost of resource and treatment with a reasonable
26 return built in and the proposition that I am making is that in any case where the new entrant
27 has lower resource and treatment costs, specific costs for resource and treatment than Thames’s
28 average, on the approach which was used by Thames in this case, it can enter because it pays
29 the same distribution charge as Thames charges to itself, but its costs for resource and
30 treatment might be smaller than Thames’s average costs.

31 THE PRESIDENT: So if we look at p.17 of the amended Notice of Appeal where there is a little
32 table of comparisons of various things, if I have understood it, Thames’s large user tariff looks
33 as if it is 42 p per cubic metre, or something of that order. I think you are simply saying that
34 between the 27p per cubic metre, and the 42p on the large user tariff there is a margin?

1 MR. TURNER: Yes, perhaps it is better to take the 13.6 because for the large user tariff that ends up
2 being the relevant comparison. The box at the top, with 13.6 in it is the one that needs to be
3 compared with the large block on the right, representing the retail tariff. The difference in the
4 size of those blocks is accounted for by Thames's average costs of resource and treatment with
5 a return built in.

6 THE PRESIDENT: Yes, but 13.6 is not in issue at the moment, it is the 27? Well the 13.6 is in
7 issue, yes.

8 MR. TURNER: Well, if you prefer, if we stay with the 27, you take the second bar from the left,
9 which is the standard tariff and you compare with that the little box on the left ----

10 THE PRESIDENT: Which is the 27?

11 MR. TURNER: -- which has the 27 in it, yes, and the margin is the difference between that box with
12 the 27 in it and the full height of the standard tariff. The difference between them is accounted
13 for by the average accounting cost of Thames's resource and treatment assets.

14 THE PRESIDENT: Yes, now Mr. Thompson has popped up to put us right.

15 MR. THOMPSON: Sir, I would just like to make it clear that our complaint in essence is that the left
16 hand bar against the right hand bar, that was the whole point and that is what troubled Ofwat.
17 But we could not realistically compete with the Thames' industrial tariff on the basis of the
18 standard access price.

19 MR. TURNER: I understand the complaint. The complaint is that they say that the relevant cost is
20 not Thames's average cost of resource and treatment, but the block representing its long-run
21 marginal cost which they say is 45 pence. That is why Albion say they cannot compete. What
22 I am saying to you, however, is that far from the average accounting cost approach being a
23 market closing approach, what it does do is leave a margin between the access price for
24 distribution and the retail tariff which represents Thames' average resource and treatment
25 costs, and in any case where an entrant's specific costs are lower than that, there is scope for
26 them to enter. The point is that they can do so, and in fact they can do so ----

27 THE PRESIDENT: You mean Thames' average accounting costs for resource and treatment?

28 MR. TURNER: Yes. Yes.

29 PROFESSOR PICKERING: Are you saying that Thames may not de-average in order to respond to
30 the reality ---- or the prospect of competitive entry by Albion or somebody else?

31 MR. TURNER: Do you mean in terms of de-averaging the distribution?

32 PROFESSOR PICKERING: No. In terms of de-averaging its own resource and treatment cost.

33 MR. TURNER: Well, that is not an issue which arises in this case because you take as a given that
34 the tariffs which Thames is charging to its customers, built up on the average accounting cost

1 basis, and Thames is not suggesting ----- and did not suggest in this case that they should be
2 different, to compete, in order to meet competition ---- the distribution charge, which is based
3 on the average cost of its distribution assets. I believe in one of the MD letters there is
4 a discussion of what might happen if somebody does come in in the margin, and Thames drops
5 its tariff to respond and says, "Well, I can do this because it is based on my specific costs".

6 That is not, however, an issue that arises in this case.

7 PROFESSOR PICKERING: But it is a logical point in relation to the argument that you are making
8 that there could be even, in your terminology, inefficient entry where the actual costs of an
9 entrant may be above the actual costs of supply by Thames ----

10 MR. TURNER: Yes.

11 PROFESSOR PICKERING: -- but lower than the average costs which would be applied by Thames
12 in determining its overall price.

13 MR. TURNER: That is absolutely right. That position, which, under the average accounting cost
14 approach, obtains if Thames is also charging its standard tariff in all cases (the average tariff)
15 could lead to inefficient entry. The question of whether Thames could legitimately respond
16 has not arisen.

17 PROFESSOR PICKERING: We understood that.

18 MR. TURNER: So, my first point, in a nutshell, is that the methodology that was used does not
19 close the door to competition in the circumstances which I have outlined.

20 The second and third points go on to consider the argument that this is an approach
21 which is detrimental to the interest of customers who end up paying higher prices, because the
22 more efficient person is squeezed out.

23 So far as this is concerned – the interests of customers and the prices they pay – the
24 result of Albion taking the business from Thames is that Thames, which has many continuing
25 obligations of supply throughout the licensed area, and which has to make continual
26 investments in water treatment and resource facilities of its own to meet all kinds of
27 requirements, loses the contribution to those assets. Albion has got the business. Albion
28 receives the price from the customer. There arises, obviously, a risk of stranded assets.
29 Thames is no longer receiving the remuneration ---- the contribution to the remuneration of
30 those assets. The result is that the cost still has to be borne because Thames has these
31 continuing duties, and has to continue making supply available throughout its area. The costs
32 have to be borne by the remaining customer base. So, where that happens, the result is that
33 other customers end up paying for Albion's entry.

1 If I may, and purely as a convenient guide, I would hand up to the Tribunal a table
2 that Miss Sloane has prepared which sets out the duties of the water companies.

3 THE PRESIDENT: Why are those other costs not being recovered in the access price? I thought
4 that was the Shotton idea.

5 MR. TURNER: I will tell you why: it is because the access price which is charged relates only to the
6 cost of the distribution assets. That is all that is recovered from the new entrant by Thames.
7 So, it does not get anything back ---- any contribution in relation to the resource and
8 treatment assets which it also has to continue to develop and invest in. It has lost the revenue
9 from the customer which would have been used to contribute to those assets on resource and
10 treatment.

11 PROFESSOR PICKERING: If you have a stranded asset – by which I assume one would logically
12 understand that the asset was no longer actually required as part of the resource and treatment
13 costs – then why do you not simply close it, and bulldoze it, and use the site for something
14 else – if it is stranded? All right, you understand the question?

15 MR. TURNER: I understand the question. There are two responses to that. The first is that we are
16 not dealing only with the extreme case of stranded assets. I should not have used the term -
17 which is a term of art – so precisely. You also have assets which you continue to use, but in
18 relation to which the contribution from customers is now reduced because some of your
19 customers have been taken away by the competitor. So, you have a smaller nub of existing
20 customers who need to remunerate the costs for the assets you are continuing to use.

21 The second response is this: that in relation to stranded assets, as you use the term
22 correctly, there is the dimension of regulatory risk. The point is that every number of years
23 the retail prices which the water companies can charge the customers are set by the regulator.
24 On each occasion, they take into account the cost of capital that the water companies must
25 pay. An element of the cost of capital is the risk that they bear. If these assets can be subject
26 to ---- if competition can lead to assets suddenly becoming the subject of needing to be
27 remunerated by a smaller group of customers, the risk increases, the cost of capital increases,
28 and in the periodic reviews that the regulator carries out, the prices set for the generality of
29 customers also increases. So, for that reason ----

30 THE PRESIDENT: It depends whether the water companies become more efficient.

31 MR. TURNER: That is true. That is also a dimension taken into account going in the other direction.
32 But, what cannot be avoided are the continuing major obligations of supply that all of the
33 water companies continue to have, and which do have to be paid for.

1 Now, perhaps, may I just ask the Tribunal to look at the table that was handed up? It
2 is only, as I say, for convenience, but what we have done is to set out a lot of the general
3 duties which the undertakers have – unlike many companies throughout industry – and which
4 they cannot avoid. If you turn, for example, to p.3 you see there, for s.37, the general duty to
5 maintain the water supply system in their area. Section 52 is the domestic supply duty – they
6 have to be able to meet the supply for domestic customers throughout the area. We have
7 simply set out the provision. At p.5 and following – supplies for non-domestic purposes.
8 Again, the provision that applies there. Underneath that is fire-fighting, and other public
9 purposes, and so on.

10 The result of this is that in the situation where there are regulated retail tariffs which
11 are designed to ensure that the water companies only receive a fair and normal return, the
12 burden of competition – and in particular inefficient competition, if it arises – falls on the
13 customers. It is not, therefore, a case ---- This is not a case about a regulator protecting unfair
14 monopoly profits of water companies ---- incumbent water companies. The concern, which
15 you will have seen from your consideration of these issues more generally, is, “What is the
16 best way to ensure that the interests of consumer, looked at more generally, are not
17 impacted?” It is against that backdrop that between the different possibilities for access
18 pricing which are available, what has happened going forward now, under the costs principle,
19 is that the Government has opted for the efficient component pricing rule.

20 May I, just before looking at that, show you an extract from the Government’s
21 consultation paper from 2002 – a short extract – in which they neatly encapsulate this point
22 about why they were thinking at that time of choosing a pricing rule which avoids the dangers
23 that I have just mentioned. (Handed)

24 MR. THOMPSON: I do not want to interrupt Mr. Turner in his flow, but I do rather wonder which
25 part – either of the defence or the skeleton argument – we are on. I have been berated for
26 raising issues that are academic and stale. I am somewhat mystified as to where all this is
27 going on the Director’s case.

28 THE PRESIDENT: Let us go on for the moment because it is helpful to the Tribunal to try to
29 understand it all, I think.

30 MR. TURNER: In para. 187, under Pricing, on p.42 there is a discussion of, in particular, access
31 charges and that they should reflect the costs of provision of the services which are provided
32 by the undertaker to the licensee. There is a reference to various methods, and how they are
33 used. But, the Government sets out certain considerations. The considerations in the second
34 bullet point are relevant to what I have just been saying. You can read that for yourselves.

1 Essentially, it relates to the problem that competition can lead to in terms of the danger of
2 assets being made redundant or becoming stranded.

3 THE PRESIDENT: One can understand the stranded asset point. A stranded asset would be, for
4 example, if the Shotton paper mill decided to construct a new pipeline from Shotton to
5 Heronbridge and the existing pipeline was no longer of any use to anyone. It would be
6 stranded. That is a stranded asset.

7 MR. TURNER: Yes.

8 THE PRESIDENT: But, I have not quite understood that we are in the stranded asset ballpark here
9 at all.

10 MR. TURNER: No. Again, I am perhaps using the term too loosely, but the idea is that even where
11 an asset – a water pumping station or something of that kind – continues to be used ----

12 THE PRESIDENT: This is talking about assets that are redundant or stranded. It is not talking
13 about anything else.

14 MR. TURNER: No. I was saying that there were two aspects to my point about the interest of
15 customers.

16 THE PRESIDENT: Stranded assets I can understand, but that is not this case.

17 MR. TURNER: In terms of pricing generally, with respect, the stranded assets point could well
18 arise, and that is one of the considerations here. I am talking about an approach to pricing
19 more generally.

20 THE PRESIDENT: What I thought you were saying was that it would be a crying shame if the
21 water companies face some competition because it would be more risky and therefore their
22 cost of capital would go up, and therefore the consumers would have to pay more. But, that is
23 what happens in most competitive industries. In most competitive industries there is a trade-
24 off between the efficiency that competition brings and whatever risk factor that may be
25 introduced.

26 MR. TURNER: That is absolutely so. The special feature of this industry is that the water
27 companies are given a large number of obligations which require them to keep in existence,
28 and to keep operating, lots of assets. Those include, for example, water supply assets which
29 have to be there to meet duties as, for example, suppliers of last resort, irrespective of the
30 competitive situation. If Thames' business is taken away from a large number of customers, it
31 does not affect its need because of its statutory obligations to keep all these assets there,
32 because it has to be ready to jump in to supply the customers if the need arises.

33 I can give you a small local example of that from the site visit. We visited the
34 Hammersmith Hospital. The Hammersmith borehole has, for whatever reason, not always

1 been operational. Thames has had to jump in and supply instead. You may have noticed as
2 we were driving away from the hospital that some works were being carried out on which
3 Thames was putting in new plastic distribution pipes instead of the old corroding metal pipes.
4 One of the comments made in passing by John Shaw (Thames' engineer on the visit) was
5 that, "It's not as though we can put in a smaller diameter pipe to recognise the fact that this
6 major customer, the hospital, is now being served by the borehole. We have to have the same
7 diameter pipe put in there because we have our obligations, and we might have to supply this
8 customer, or other customers, at a moment's notice".

9 It is because of the particular situation of this industry, with its peculiar regulated
10 features, that the consideration is of greater weight than it might be in many other industries.
11 I am not seeking to excuse it. All I am seeking to do is to assist the Tribunal to understand
12 some of the thinking behind the considerations that go into access pricing, and which
13 ultimately have led the government to introduce a rule based on the efficient component
14 pricing dimension under which undertakers are remunerated for their existing assets, and an
15 access price is calculated going forward by reference to cost savings which are made. What
16 I was trying to do was to try to help the Tribunal to understand why it has happened.

17 THE PRESIDENT: We do need very much to understand it all.

18 PROFESSOR PICKERING: Mr. Turner, would it be appropriate to describe what you have just
19 been saying as really if not applying to stranded assets as such, applying to the situation
20 where capacity utilisation is reduced – for example, in relation to a treatment plant – and on
21 the basis that there are significant economies of scale up to maximum utilisation, if the
22 throughput through that plant drops, then presumably each unit that does continue to go
23 through, and is treated there, will need to bear a higher proportion of the total costs that
24 would otherwise have been spread over a larger volume if the previous higher capacity
25 utilisation had been maintained.

26 MR. TURNER: That is the point.

27 PROFESSOR PICKERING: Is that the point?

28 MR. TURNER: That is the point.

29 PROFESSOR PICKERING: Thank you.

30 THE PRESIDENT: Presumably, in the Hammersmith example, the hospital pays something for the
31 availability of the stand-by supply? It is not just free.

32 MR. TURNER: I would have to check whether they pay a supplier of last resort charge, as it were,
33 or how things work when the borehole breaks down. I am not familiar with that.

1 Now, that, therefore, is the question of how the average accounting cost methodology
2 which was deployed in this case works, and why it is not a market closing access price.

3 To address the legal question of whether either the average accounting cost approach is
4 a margin squeeze under competition law, or the ECPR approach which will now come in under
5 the amended Act is a margin squeeze, I would make the following brief submissions, and say
6 that so far as the average accounting cost price is concerned, it can be considered a fair price
7 for the purpose of competition law for these reasons. First, Thames is charging others for
8 distribution what it charges itself – that relates to para.117 of Telecoms' Notice.

9 THE PRESIDENT: I thought it was charging itself its long run marginal cost rather than its average
10 accounting cost?

11 MR. TURNER: No, if you imagine a separate entity, Thames Distribution which is charging either
12 Thames Resource and Treatment, or Albion for carrying water through the system, it charges
13 them both the same price, which is an average price calculated to be a fair return ----

14 THE PRESIDENT: The average accounting cost of resource and treatment.

15 MR. TURNER: Of the distribution assets.

16 THE PRESIDENT: Distribution assets, yes.

17 MR. TURNER: And no more than that. The second point is that Thames therefore earns a normal
18 regulated profit in the access price it charges.

19 THE PRESIDENT: Yes.

20 MR. TURNER: The third point is one that it is consistent with the basis of average charging to
21 Thames's own retail customers which is arrived at for social policy reasons and with which
22 nobody is quarrelling.

23 The fourth point is that the methodology is reasonably straightforward. Although
24 there can be lots of confusion about the numbers which are used in an average accounting cost
25 approach one thing you cannot gainsay is that the numbers are there, they are verifiable from
26 the accounts.

27 THE PRESIDENT: They are historical and all the rest of it?

28 MR. TURNER: Actual as opposed to forward looking. It is much more difficult to take forward
29 looking estimates over a long time frame. The fifth is that it does allow entry by competitors
30 in areas of low cost, by which I mean low resource and treatment cost, and it does so even if
31 they are inefficient competitors.

32 So far as it is an issue, the efficient price component pricing rule we would say is also
33 a fair price under the Competition Act because it allows entrants into the market wherever it is
34 efficient in the sense of leading to lower overall costs for the generality of consumers. In

1 relation to the point Mr. Thompson was making yesterday, on the approach which you will
2 now find under the Act it always gives credit for the benefit of the totality of water introduced.
3 That is the basis of the approach, that where there is a cost saving credit is given.

4 THE PRESIDENT: You say it always does so, but it would still be a question of fact, would it, as to
5 whether it was a benefit or not?

6 MR. TURNER: Yes, but the idea behind it is that where you can avoid costs, where the water
7 company avoids costs because of the new resource that has come on stream, where its own
8 water resource obligations, capital expenditure can be deferred or avoided, for example, the
9 benefit is reflected in the access price which is charged.

10 THE PRESIDENT: That is certainly a point I would like a bit of help on at some stage when
11 convenient. In this particular case it seems to be being said that this particular borehole looked
12 at individually is too small to enable Thames to avoid any future investment or charge. How
13 do you cope with a situation where, looking at a number of individual projects individually you
14 could not say that that particular project, taken in isolation would necessarily help to avoid
15 some future investment. But if there were 10 of these boreholes or 50, 100 or 5000 in London
16 all waiting to be developed, and there was somebody there to develop them, it might have quite
17 a significant effect, and how would that system effect be picked up in whatever is being
18 envisaged here?

19 MR. TURNER: May I make two responses to that? The first is just a point of factual clarification, it
20 certainly is not an issue in this case that Thames is saying "This little borehole would not cause
21 us to avoid any significant costs". They said that for another borehole and that has been
22 referred to in the papers. What has happened in relation to our boreholes is that Thames did
23 say "We will charge for access on the average accounting cost basis for the distribution assets
24 and we will honour that commitment going forward until the statutory regime comes into
25 play". They said "We will honour it even though we are moving over to another basis of
26 pricing more generally."

27 So far as the question relating to a large number of boreholes is concerned, if an
28 entrant were to come along and said "I have 20 boreholes across London in these particular
29 areas, the total yield of this is X (14 mega-litres a day) and I would like to have a price for
30 bringing this on stream." Then assuming that this is one project, and can be looked at as one
31 project – someone will correct me if I go "of piste", then that would all be taken into account
32 under the efficient component pricing rule, and if costs are deferred or avoided then it would
33 be fair to take that into account. The problem is that in our case, as I began by saying
34 yesterday, that was not the issue. What Albion have done is to come along with two specific

1 very small boreholes by way of proposals, and those are the subject matter of this case.
2 Everything else must be regarded as too uncertain to count in such an access pricing
3 calculation.

4 THE PRESIDENT: It is interesting to discuss the theory – I am not necessarily suggesting that what
5 we are talking about at the moment is necessarily relevant to our case – but two thoughts come
6 into one’s head. First, does that last answer imply that in order to effectively take advantage of
7 the new system you have to, as it were, acquire, the kind of critical mass where you can show a
8 reasonable saving of investment, i.e. if you were one entrant who had assembled 20 boreholes
9 you might be in one position, but if you were 20 entrants, each of whom had one borehole you
10 might be in a different position. That would be the first question.

11 The second question is, supposing in this particular case it had been decided that there
12 was a certain access charge and, as a result, these particular two small boreholes had been
13 developed, or had started, and it had then been seen that there was, as a result, a market
14 opportunity for other people who might want to bring boreholes in London on stream, then for
15 all we know you may get 50 of these things springing up because the initial one or two have
16 blazed a trail it has opened up this new resource; and how does this new system work in a way
17 that does not, as it were, throttle off that possibility?

18 MR. TURNER: Yes.

19 THE PRESIDENT: You do not have to deal with these questions now, Mr. Turner, they may be
20 complicated questions. They may not even necessarily be relevant – certainly not necessarily
21 to this particular case, although they may have a distant bearing on Shotton, but it useful for us
22 to try to understand it.

23 MR. TURNER: What you are raising are general questions testing the boundaries of how the new
24 regime will work, which is entirely fair. The best statement of how the new regime will
25 actually work is to be found in the draft guidance which is in the papers, in bundle 8, tab 17. It
26 may be worth your while just having a look at that, it was referred to by Mr. Thompson
27 yesterday. But this is really as far as it goes, as I understand it in terms of the documentation.
28 At p.55 on tab 17, there is the reference to how prices will be calculated, and in broad terms
29 you see indicative common carriage prices on p.55 and over the page at p.57 case specific
30 common carriage prices when the matter is firmed up afterwards.

31 THE PRESIDENT: Yes.

32 MR. TURNER: And looking at the second paragraph under the heading “Indicative Common
33 Carriage Prices”, there is a reference to the way to calculate the benefit of cost savings
34 associated with rescheduling capex, is to compare two investment plans – that is the particular

1 water resource zone – that would be something, I should add, much smaller than the entire
2 Thames’ area. Actually, while I am on that, for the record, the water resource zones in which
3 each of our boreholes fall are described in the papers. I may have to get you the reference.
4 There is a letter of 21st December 2000, bundle 3, p.46 – I do not ask you to turn it up. At 2.6
5 in that letter you will see that the Albion Yard borehole falls in the Mile End supply zone of
6 the network, and the Bath House borehole falls in the Bethnal Green supply zone.

7 THE PRESIDENT: Yes.

8 MR. TURNER: Those are the zones that will be taken into account, as I understand it for this sort of
9 calculation, but you compare investment plans over a long period going forward both with and
10 without the actual resource, which would be added and you see what the benefit is and that is
11 modelled in a simplified way at the bottom of p.55.

12 That is a draft which was subject, as I am reminded, to detailed consultation which
13 has taken place over the last six months or longer, and the final version of this is to be
14 published soon.

15 THE PRESIDENT: How soon is “soon”?

16 MR. TURNER: Within the next week or so.

17 THE PRESIDENT: Good.

18 MR. TURNER: That is as far as we have actually got on the large conceptual issue, Sir, that you
19 have raised on the documents. So far as your two questions are concerned, in the first case
20 where you have someone who comes along with 20 boreholes as opposed to one person who
21 comes along with ----

22 THE PRESIDENT: 20 people who come along with one, yes.

23 MR. TURNER: You are better off because the whole project is looked at on the basis of the 20
24 boreholes. So far as the question of experience is concerned, and the more probing question
25 about what happens if you can ascertain that a borehole is viable by the initial project? I am
26 afraid I am unable to help you further at present.

27 THE PRESIDENT: Yes, all right.

28 MR. TURNER: So that is basically it on margin squeeze, save only for one point which I apologise
29 for profusely, I noticed this overnight, there is a potentially relevant authority under
30 Community law, at least of indirect relevance which I desire to draw to the Tribunal’s
31 attention. It is *Corbeau* from 1993, and I hope Miss Sloane has some copies available. Sir,
32 may I come back to that, it may be more convenient to leave it. The short point is that I would
33 wish to show the Tribunal a short authority which provides at least indirect support for the

1 view that the European Court might consider pricing rules which are designed to ensure that
2 the generality of customers are not prejudiced, not to infringe the European Competition Rules.

3 THE PRESIDENT: Yes, the Royal Mail – I can see it is a case without the mail – but the Royal
4 Mail in particular faces very much the same problem that you are talking about, I think, it is
5 a universal service, and the common charge irrespective of the location of the customer has
6 obvious similarities with some aspects of water. It may be that the water situation is much
7 more complicated – it probably is – but the conceptual problem is similar. It is for that reason
8 that we draw your attention to it. Essentially, there is a postal monopoly under Belgian
9 legislation and the issue concerned a prohibition on others from providing certain competing
10 services. In para. 4 you see what Mr. Corbeau wanted to provide in the City of Liège and the
11 surrounding areas, was a service consisting in collecting mail from the address of the sender
12 and distributing it by noon the following day and so on. There was discussion by the Court of
13 Justice of the justifiability of this prohibition. I accept that this is only of indirect relevance,
14 but if you turn to paras.15 to 18 on p.4, para.15 records that the Rège des Postes is entrusted
15 with the service of general economic interest and it provides its postal service at uniform
16 tariffs and on similar quality conditions.

17 16 the question which falls to be considered is the extent to which a restriction on
18 competition or the exclusion of all competition from other economic operators are necessary in
19 order to allow the holder of the exclusive right to perform its task, and so on. Here we are not
20 concerned with any such restriction on competition or exclusion of competition, except in a
21 general sense we are talking about an access pricing rule under the average accounting cost
22 methodology, and whether that is justifiable. In paras. 17 and 18 there is a recognition by the
23 European Court, at least in general terms, that the person with the universal obligation has to
24 be able to avoid cherry-picking in its core areas of business. That is the only point I derive
25 very indirect relevance from that case is that the European Court might therefore consider that
26 in our case access pricing, which is designed to avoid prejudicing the generality of customers,
27 should not be considered to be an unfair price within the terms of the competition rules. I do
28 not go any further than that.

29 THE PRESIDENT: Is this a schedule 3 para.4 point, effectively?

30 MR. TURNER: Is schedule 3, para.4 the paragraph about ----

31 THE PRESIDENT: The services of general economic interest.

32 MR. TURNER: That was the relevance of that case. The point which I draw from the case would be
33 applicable in a slightly different situation. We are not now concerned with saying that all
34 competition against the water companies should be restricted for reasons of general economic

1 interest. What I am trying to do is to see whether an access price, which allows some entry,
2 would be deemed to be unfair and, if so, what considerations the European court might think
3 were relevant to that analysis. Sir, unless the Tribunal has any further questions?

4 THE PRESIDENT: This is a difficult area, is it not, Mr. Turner, because those of us who are old
5 enough can remember the time when it was illegal to send a parcel otherwise than through the
6 Post Office, and courier services were illegal, and bit by bit the monopoly has been cut back.
7 I think it is going to be cut back even more in the near future – or may already have been. In
8 this particular case we are talking about large users, indeed, the new Act talks about large users
9 as and opening up a certain amount of competition for large users. So it is a very complicated
10 area.

11 MR. TURNER: There is no suggestion whatsoever that there is anything illegitimate or untoward,
12 simply to explain, in particular in relation to the efficient component pricing rule, the
13 considerations that have perhaps underlain the Government's approach.

14 THE PRESIDENT: Yes.

15 MR. TURNER: Totality. The claim by Albion is that credit should be given by a water company in
16 order to recognise the costs saved in resource and treatment by the addition of its resource in
17 total. The first point that I desire to make, is to note the consequences of Albion's argument
18 for the level of the access price which they say should apply. On p.21, just the second part of
19 that paragraph, they say, correctly, on their approach, "For competitive supplies to large
20 customers, the appropriate access price would be nil pence per cubic metre, arrived at by
21 taking the large user tariff and minusing the published general long-run marginal cost figure of
22 45 pence". So, if anything, a very small negative price.

23 Now, what they have done there is, in fact, as you will appreciate, a very crude
24 variation of the efficient component pricing rule approach in which they are seeking to say
25 Thames is better off, and that what you should deduct from the tariff price (the retail price) is
26 the LRMC. They take that as the measure by which Thames is better off. So, effectively, it is
27 a funny kind of ECPR approach. What they then go on to do, and what Mr. Thompson was
28 referring to yesterday in submissions, as an alternative perhaps, is to suggest that you do not
29 start with the retail price and take away the long-run marginal cost; you actually should start
30 with the access charge for distribution of assets and then take off from that the long-run
31 marginal cost figure. That produces a big negative price.

32 THE PRESIDENT: So, they should be paying Albion basically.

33 MR. TURNER: So, they should be paying Albion to the tune of 18 pence for every cubic metre.

34 That submission, which Mr. Thompson referred to yesterday, you find in their reply, but you

1 can find it most conveniently in Bundle 3 at p.168. It is Tab 3, the correspondence. There is a
2 table there which sets out projections by Albion for its profitability from the boreholes. This is
3 a table which was produced for OFWAT in December 2001, and it is reproduced in the reply.
4 What you see from it, leaving aside the bullet points relating to assumptions above the table,
5 are that they have taken different ---- in the first column – the fifteen year profit value ----
6 different assumptions about the profits that they would get from the borehole over fifteen
7 years, depending on different assumptions as to the access price that would be charged for
8 common carriage. You will see that it is only in relation to the situations where there is a
9 negative access price of minus 18 pence that a profit figure is shown. To explain that negative
10 figure of 18 pence you go to the top of the page where they clarify that what they have taken is
11 the network access price – that is, the 27 pence – and they have taken off from that the
12 published LRMC value to get to minus 18 pence.

13 This is the point at which we say there has been a complete confusion of
14 methodologies. We are not now just into a crude variation of the ECPR approach which you
15 saw in the Notice of Appeal, giving you nil. You are now into taking the access price arrived at
16 on the average accounting cost basis for distribution assets, and then taking off from that a
17 public long-run marginal cost figure for resource and treatment for Thames generally.

18 Now, I will deal briefly with both of those approaches. First, the one in the Notice of
19 Appeal where they take the retail tariff price and net off from that the long-run marginal cost
20 for resource and treatment. We say in relation to that that it is fine to adopt the approach of
21 looking for the cost savings to Thames and starting from the retail tariff, and that is indeed the
22 approach under the ECPR rule. So, it is fine in principle. But, taking off the long-run marginal
23 cost figure published by Thames is wrong, because that is the wrong number. It does not
24 reflect the cost saving, the value to Thames. Thames retains legal responsibility for meeting
25 demand for water in almost all of London. So, you cannot just say that for every unit that
26 Albion puts in Thames scales back a unit of its production. You need to look to find out the
27 specific costs avoided. That is why you compare two investment plans over an appropriate
28 time frame – say, twenty-five years: one of them, the investment that is needed going forwards
29 without the addition of the new resource; the other one with the addition of the new resource
30 (let us say, the borehole) to compare the difference. That is the approach that is adopted in the
31 draft Access Code Guidance which I took you to a few moments ago. So, that is why there is a
32 misunderstanding in the Notice of Appeal.

33 As regards the second proposal, which is more extreme, where what they do is they
34 take the average accounting cost for distribution and then take off from that, rather than the

1 retail price, this long-run marginal cost figure for resource and treatment ---- That is a
2 confusion of methodologies. The average accounting cost approach in which they just charge
3 the average amount for the distribution assets compensates Thames fairly for the distribution
4 assets alone. It means that Thames' distribution arm charges Thames' resource and treatment
5 arm, and Albion, the same price, and it earns a normal profit. Once you say, secondly, that
6 Thames also has to be given ---- it also has to give credit for being better off because of the
7 competitive supply from Albion (because that leads to cost savings on resource and treatment
8 expenditure), you have to take into account that Thames is also losing the retail revenue from
9 the customer. It is losing the business. You cannot just take off the costs without also
10 remembering that you are losing the customer and the money you would have got from the
11 customer. That is why the starting point which necessarily has to be used, if you want to claim
12 that the incumbent is better off, is the retail price as in ECPR, as in the Notice of Appeal. But,
13 Albion does not do this on this approach.

14 Another way of looking at the matter is that the average accounting costs of the
15 distribution assets is itself arrived at by taking the retail price and deducting from it the average
16 cost of resource and treatment of assets for the period over which you have competitive supply.
17 In other words, the way that this average accounting cost figure for distribution assets is
18 arrived at is that Thames takes the retail price – the tariff – and knocks off from that the
19 resource and treatment ---- its average resource and treatment costs.

20 So, taking the retail price as the starting point, Albion is already receiving a credit
21 when it gets the average accounting cost access price for the average costs of resource and
22 treatment over the period of the competitive supply. When you think about it, it is a form of
23 double-counting to not only deduct the average cost of resource and treatment from the access
24 charge, but then also, as Thames would have it, to deduct again the specific costs of resource
25 and treatment assets. That is why you get these huge negative figures of minus 18 pence.

26 In line with that, the point, sir, that you canvassed with Mr. Thompson yesterday is
27 also right, about being paid twice. If Albion pays an access charge to Thames which is based
28 on the average accounting cost of the distribution assets, and there is a deduction for the full
29 whack of resource and treatment, it is effectively asking to be paid twice for water ---- for
30 every unit of water it puts in. The customer pays Albion for the water, and then Thames pays
31 Albion the full marginal cost for water on top of that – even though Thames receives no
32 contribution to its own water assets.

33 So, to conclude, in relation to the point on totality, which was never in the s.47
34 procedure at all, there is confusion, and it is mis-conceived.

1 Sir, if I may, after lunch I can deal very quickly with the question of credit for over-
2 supply and the residual point. And that will conclude my submissions.

3
4 (Adjourned for a short time)

5
6 MR. TURNER: Sir, first we have copies for you of a letter dated 16th June, which was set out by the
7 Director, and says that the new regime will come into force.

8 THE PRESIDENT: Yes, I think we have seen this. That is the licensing regime.

9 MR. TURNER: I am sorry, I had not appreciated that. The second point is, Sir, you were right, the
10 issue of the extent to which the framework is discussed in the first *Freeseve* case, para.116,
11 which can be found in the bundles...

12 THE PRESIDENT: We can refresh our memories, it does not matter, Mr. Turner.

13 MR. TURNER: It is para.116. The key point is that you are entitled to raise points which were not
14 raised if you are the complainant, but p.39 para.116, half way down:

15 “We accept, however, the Director’s basic argument that in principle the original
16 complaint sets the framework within which the correctness of the Director’s Decision
17 is to be judged, taking account of the material that he had or ought reasonably to have
18 obtained.”

19 THE PRESIDENT: Yes.

20 MR. TURNER:

21 “An Appeal is not an occasion to launch what is, in effect, a new complaint, and then expect
22 the Director and the Tribunal to deal with the matter on the entirely new basis.”

23 THE PRESIDENT: Yes.

24 MR. TURNER: Just to draw a few strands together from what I was saying before lunch, before
25 I leave entirely the question of fair price and giving credit for alternative water resources. The
26 points I think are these. The average accounting cost based price reflects a fair value for the
27 distribution assets which are used to convey the water. This is one of a number of possible
28 approaches to access pricing and, as you saw, from the parts of MD163 that we looked at this
29 morning, the judgment of the Director is that this is an approach that is more likely to be ... in
30 competition than some other approaches, and in particular an approach based on giving
31 specific credit for avoided costs, which is the ECPR approach – it is more entrant friendly.

32 THE PRESIDENT: So AAC is more entrant friendly.

33 MR. TURNER: Yes, in general that was the view taken in MD163 and you will remember there the
34 comment that letting in competition, even if it has rough edges could bring some benefits.

1 It is wrong, however, to do what is now suggested in this Appeal, which is to deduct
2 from the average accounting costs for distribution assets charge, some figure representing the
3 specific costs of resource and treatment avoided for the reasons I gave this morning. For
4 clarity the discussion that we had about inefficient competition and how it can lead to higher
5 regulated prices – the cost of capital argument – was relevant really to only one point and
6 I would like to make this point because I do not want it taken out of proportion or suggested
7 that we were opening up a new area, and that was only the point raised in para.2 of the
8 amended Notice of Appeal that prices were higher than they otherwise would be if Albion had
9 come in with its two boreholes. The essence of it is simply that it is not as simple as all that,
10 and nor is the Director General saying “It is a shame if there is competition because it pushes
11 up the cost of capital”, that is certainly not our approach. It is however an explanation for the
12 approach that the Government has taken in introducing the new statutory regime.

13 THE PRESIDENT: Is that right, Mr. Turner? Or if it is right where do we find it written down
14 anywhere, because one of the perplexities of the new statutory regime is that it announces, the
15 statute announces very early on that its intention is to promote competition and a lot of what
16 you were telling us this morning was suggesting that, at least compared with an AAC
17 approach, EPCR only in rather restricted circumstances promotes competition. There seems to
18 be a major tension there.

19 MR. TURNER: The thinking behind ECPR is that it will allow competition where it is efficient.
20 That is the way that the rule is constructed that wherever the new entrant can come in with
21 cheaper specific resource and treatment costs then there will be an opportunity for it to do so
22 and it can come in without the danger of prices being raised to consumers who are not subject
23 to the competition. So the thinking is that it allows competition, opens the door to competition,
24 sets it on a proper basis because there is a detailed regime, while also protecting certain
25 regulatory interests. That, of course, is not this case. This case is concerned with a period
26 before the introduction of the new regime ----

27 THE PRESIDENT: Absolutely.

28 MR. TURNER: -- and where the debate is about the average accounting cost methodology. In that
29 connection Albion’s case is that the access accounting cost methodology itself should be
30 further revised to knock off specific resource and treatment costs from the charge, yielding
31 a big negative price which Thames would have to pay to Albion. What I sought to do this
32 morning was to explain why that is conceptually confused and quite misconceived. Certainly
33 that would lead to a lot of competition. It is not right.

1 Subject to any further questions the Tribunal may have I propose to move to the
2 question of credit for over supply.

3 THE PRESIDENT: Yes.

4 MR. TURNER: The first point to clarify from an issue canvassed this morning is what a supply zone
5 deficit means, Sir. You asked me what does it actually mean? It is addressed in the documents
6 very briefly at p.219 in bundle 3, tab 3.

7 THE PRESIDENT: Yes.

8 MR. TURNER: This is the second page in the publication of the file closure decision.

9 THE PRESIDENT: Yes, we have looked at this before.

10 MR. TURNER: In the third full paragraph on the second page there is a discussion of over-supply
11 and clarification that a supply zone deficit is where there is a risk that a licensed water
12 undertaker would not be able to meet customers' demands for water during a dry year in the
13 relevant area. Therefore, it is not saying that there is not a shortage – you cannot get the water
14 to people. It is saying that there is a risk which arises that you will not be able to meet
15 demands in a dry year. It is a question of security of supply – what margin there is; the
16 capacity that is available to meet the problems that might arise in the dry period.

17 The second preliminary observation picks up on the points that were canvassed by
18 yourself and Professor Pickering yesterday – that it is to some extent a puzzle that this is an
19 issue at all because Thames is offering Albion a supply envelope with reconciliation on
20 a monthly basis for overs and unders, and there is a margin of tolerance. It is repeated over
21 and over again in the documents that it is only in serious cases of over-supply that Albion
22 would be asked to reduce the rate of input so as to bring it into balance with its customers.
23 I will just give you a reference to that for the moment – you will find it again in Bundle 3, Tab
24 3, at p.150 – Thames' letter of 21 September, 2001 (ii) and (iii).

25 Now, the third point, which is a point of fact, and which is not well-covered in the
26 documents, relates to the question of permanent value – that if water is just pumped into the
27 system, is it not always there month after month, year after year, available to be drawn down to
28 meet the crisis that could arise in a hot spell in one year? The answer is, as we understand it, is
29 not. If, in the normal period, water is simply pumped into the system, then it may lead to
30 a slight backing up in a reservoir somewhere; it engages the balancing facilities of Thames (as
31 you will see from the document), and the water needs to be stored and managed. But, whether
32 that water is still there and available to meet a dry spell that may eventuate months or years
33 hence is another matter.

34 THE PRESIDENT: Because? Because it is an equivalent volume ----

1 MR. TURNER: Well, that therefore you simply fill everything to capacity and this contributes to
2 keeping everything there – either because of leakage or evaporation – from month to month
3 and year to year. You cannot say that water pumped in all the time is always of a benefit - let
4 along a benefit equivalent to the level that at least in the documents Albion seems to be
5 suggesting.

6 Now, perhaps we ought to start with the reasons that were given on this issue in the
7 s.47 letter on 6 August, 2002 for asking the Director to re-open his file, and the response that
8 was given in the letter of 1 April, 2004. So, perhaps if you could open Bundle 3, Tab 3 again,
9 and turn to the Director's letter of 1 April, which begins at p.274. Overs and unders is dealt
10 with beginning at the foot of p.276 and over the page at 277.

11 THE PRESIDENT: I have the impression that we have already covered quite a bit of this, have we
12 not, Mr. Turner?

13 MR. TURNER: Yes. Yes. The key part of the complaint which was made, which you will find in
14 the letter from Albion, is that there was necessarily and obviously a benefit – a net benefit – by
15 injecting water into Thames' system. Simply put, the response notes first that there is no value
16 from unpredictable and intermittent inputs into a part of the network (that being understood as
17 not being because the borehole output is fluctuating, but because you do not know when
18 customers' demands are going to be out of balance and there is going to be water left over);
19 secondly, the point that surplus water is likely to be available when least needed – in other
20 words, for much of the time it is wet; and, thirdly, that hydraulic management of the system is
21 hindered by water being injected when it is not required because Thames also has a hydraulic
22 task of managing its system.

23 The mistake made by Albion, in a nutshell, is that there is an assumption that any
24 injection of treated water into the system in any circumstances is of value to Thames and has to
25 be paid for. And it is not. Haphazard surpluses from Albion caused by fluctuations in the
26 customer demand just means increased difficulty in hydraulic management, and water
27 becoming backed up in the storage reservoirs.

28 If you turn back in the file to Thames' letter of 31 July, 2002, which is on pages 204
29 and 205, this was also specifically referred to and quoted in the decision letter, and this makes
30 the point that control on what is put into the network is an important dimension. At the end of
31 that letter there is the reference to times when the incumbent has surplus water - which is most
32 of the year for most years. The cost to the incumbent is far in excess of the marginal costs of its
33 own production, and overall this increases costs and is an uneconomic outcome. In water
34 resources terms, it is better to leave the surplus water in the ground and tap it when there is

1 a dry year rather than use it in years of surplus.

2 THE PRESIDENT: Can I just be clear? This is Thames saying this?

3 MR. TURNER: This is Thames saying this.

4 THE PRESIDENT: And is it the Director's position that it is better to leave this water in the
5 ground? Is that the Director's position as well as Thames' position?

6 MR. TURNER: Not necessarily from these particular boreholes – because that was not looked at –
7 but simply the point that it cannot be assumed that every injection of water at all times into
8 a network is of value. This is pointing out that you have to look at the circumstances to decide
9 whether that is the case. That, I think, is the only point ---- that is the key point which the
10 Director is making in response to the argument that there should necessarily be equivalence ---
11 - a payment made to Albion whenever there is a surplus into its network above the customers'
12 demands. The response is, "We rely on what Thames have said here. It depends on the
13 circumstances".

14 You see this also in Thames' own asset planning processes. We looked at p.265, at the
15 little flow chart that they attached to one of their letters in which they made clear that for any
16 particular borehole they do not simply assume ... source of water that all water is a benefit.
17 They look at matters such as the need of the case for that particular water; the location of the
18 source; and the impact in relation to the catchment and growth planning.

19 Finally, these points are all repeated in Thames' contemporaneous evidence for the
20 Tribunal today, and with Mr. Tupper's permission I will simply give you some references there
21 on these points: the importance of control, so that Thames can decide when to bring on
22 capacity in that part of the system, and take it into account in its planning; and, secondly, the
23 need to use balancing capacity to deal with any unpredictable surpluses resulting from
24 fluctuating customer demand. If you take up the Statement of Intervention bundle, you see
25 these points made by Thames now. At Tab 9 in Bundle 4 is Mr. Cresswell's statement. At
26 paras. 19 and 20 he refers to how Thames has operational processes in place for predicting
27 customer demand and balancing the system, and the process is based on quantified outputs
28 from reliable sources which are under our control. In contrast, the volume of the over-supply
29 from Albion's boreholes would not have been predictable because it would be the surplus that
30 remains after the customer has taken its unpredictable demand from the supply. It is dependent
31 on customer demand, a process over which Thames has no control. Thames cannot scale back
32 production, and so forth.

1 That was Mr. Cresswell. Similarly, Mr. Casey - at Tab 10, paras. 12 to 13 – deals
2 with what is needed to be done in relation to unpredictable requirements for balancing. He
3 says at para. 13 in particular,

4 “When an over-supply is made to our network, in addition to the requirement to scale
5 down production at our treatment works, it may reduce our storage capacity as we
6 attempt to balance this surplus in the system, and this in turn reduces our own
7 flexibility, and in some instances may trigger the requirement for new storage
8 capacity”.

9 Now, there is certainly no suggestion that in this case water from these two boreholes would
10 lead to a new storage capacity being required, but in general you see the point that you cannot
11 assume that automatically surpluses being introduced should give rise to a credit.

12 Finally, Mr. Pittaway at Tab 1. Mr. Pittaway, at the end of his statement, has a table
13 in which he takes issue – or, Thames does – with statements of fact in the Appellant’s case.
14 At Point 4 of that table, in the right-hand column, Mr. Pittaway points out that it cannot be
15 assumed that the introduction of a new source will automatically reduce pressure in the local
16 network; it depends on a number of factors, including the source location in relation to the
17 customer, and any requirement for the source to pump to a storage reservoir at times of
18 reduced demand.

19 Similarly, 8. The first bullet point. Mr. Pittaway points out that Albion’s source will
20 not at all times match the customer demands, and this means that there will be unpredictable
21 surpluses and shortfalls in supply with the corresponding requirement for network balancing.
22 Finally, 16 and 17. Mr. Pittaway points out that, first of all, its control is important in terms of
23 dealing with variations in flow, and that is not the case with a new entrant whose source
24 output is not within Thames’ control. Over the page he actually gainsays the proposition that
25 all Thames’ smaller borehole sources are run at a steady rate. That was the question of fact
26 we touched on earlier. In 17 he says, “It is not correct to state that the full input of 20
27 megalitres a day could be as easily accommodated by existing balancing mechanisms, and
28 that each case Thames needs to work out whether it needs additional balancing
29 requirements”.

30 So, that is the state of the evidence in relation to whether water injected as surplus
31 into the system is automatically of value. We say the Director was entitled to find as he did, on
32 the evidence he had at the time, that that was not necessarily so.

33 Sir, that covers all of the areas of the case. There is one final residual point,
34 which is paras. 33 and 34 of our skeleton.

1 THE PRESIDENT: Do we need to go into this, Mr. Turner? I mean, if there is no issue as to ----

2 MR. TURNER: There is no issue as to admissibility, and I say not. Sir, those are the Directors'
3 submissions.

4 THE PRESIDENT: Thank you. I am sorry, Professor Pickering has a question.

5 PROFESSOR PICKERING: Could I just ask, Mr. Turner, these two boreholes that we have been
6 addressing relate to two separate water resource zones in London as I understand it. I wonder
7 if your clients are able to indicate to us what has been the general trend in consumption of
8 water in those two water resource zones over the last five, ten years, and what is the forecast
9 trend in consumption over the next five years, please?

10 MR. TURNER: I am confident that I cannot address that at the moment! (Laughter) But I will take
11 instructions, but I think that Thames would be better placed, because we would have to ask
12 them for the information.

13 THE PRESIDENT: Yes, Mr. Tupper?

14 MR. TUPPER: I am expecting to hear the sound of pen work behind me as I speak, and I am sure
15 they will be able to provide you with some indications.

16 THE PRESIDENT: Thank you very much.

17 MR. TUPPER: Obviously it is a long time to be warming the subs-bench, as it were, and especially
18 given that some of the players in the field have shown off my best tricks. I hope the Tribunal
19 will indulge me if I find myself repeating some of the things that have already been said.
20 Indeed, in fact, listening to all of the commentaries, these are the papers that have been passed
21 to me thus far, so I obviously have to try and cover as many of those as possible, but you will
22 be delighted to hear that I have worked on the speech over the weekend which I have managed
23 to shrink down, and there are a few reasons for that. One of the reasons obviously is that the
24 case itself has, before our very eyes, shrunk and, in fact, if we were to take the Tribunal's
25 summation of what is left, which is an issue concerning excessive pricing, an issue
26 concerning margin squeeze, overs and unders and totality, those four issues are connected by
27 one single point, and that is should Thames have given a credit of some sort for the water that
28 was going to be at some point in the future put into its system. You can take the Albion case,
29 you can turn it upside down, and you can shake it as hard as you like, but the only penny that
30 will fall from the pocket is that one. There is nothing more to it than that.

31 Sir, I will, if I may, just focus on that single issue, because in my humble submission
32 that is all that is currently before the Tribunal. Before, however, I dive into it and try to
33 explain once more why Thames was unable to give any credit – something, by the way that
34 Thames until it was blue in the face, attempted to explain to Albion but obviously failed to get

1 its message across – I would like to scotch, if I may, one or two of the mythologies that have
2 grown up in the course of the presentations.

3 First, in terms of mythologies we move on to methodologies, the actual accounting
4 cost methodology. It is, as it sounds, and as stated, a methodology. It requires those that are
5 applying the methodology to follow it scrupulously. Failure to do so will obviously create
6 problems in the future. Deviations are not to be tolerated under water law, and competition
7 law on the basis of our position and obviously on the basis that we are not allowed to
8 discriminate, etc. There is a rule book; we followed that rule book to the penny to produce our
9 price, in fact, let me just correct that, not our price, but our two prices, and we will come back
10 to that. Interestingly, Albion likes the accounting cost methodology, and if I can just invite you
11 to turn to para.35 of the Amended Notice of Appeal you will see in the second part of that
12 paragraph:

13 “Although Albion contends that the offer access prices were roughly calculated and
14 failed to reflect the value to Thames Water of the new resources, it will not contest the
15 Director’s Decision in relation to the average accounting cost component of the
16 offered access prices referred to in complaints 1 and 2”.

17 The shorthand is they like the price. Not only do they like the price, they like the
18 methodology and, indeed, probably Albion is thinking to itself now it should have bitten our
19 hands off. However, what they would like, and Mr. Turner dealt with it in some detail, is not
20 to have one methodology but to have that methodology plus a little bit of another, because
21 when we said that the provisional access price was 27p they then said at some point – the
22 continuum – “What about the value of the water?” As Mr. Turner has pointed out in some
23 detail value of water is where you move to another methodology. It puts you into another rule
24 book. Now, that rule book is an efficient component pricing rule. Again, if we refer to the
25 amended Notice of Appeal at para.52 you will see what we get when you apply deficient
26 component pricing rule by Thames in a case similar to this, and indeed it would have been a
27 price which would have been identical which is 31.9p. Now 31.9p is obviously more
28 expensive (4p more than 27p and considerably more than 13.6p). But that is what you get.
29 That is the number you arrive at when you use efficient component pricing. So when we used
30 the actual accounting cost methodology we obviously came up with a different number, a
31 number that is different from 31.9p.

32 I have been struggling to find a metaphor to try and describe what it is that Albion is
33 asking this Tribunal to do. The best I can do, and it is of course the sports *du jour*, is to give
34 you a conversation between Ricky Ponting and Mike Vaughan on the eve of a Lords’ Test

1 Match. “Michael, why don’t we play the offside rule? I saw a game of football last night and I
2 liked it”. Michael says “I’m sorry but we’re playing cricket here, Ricky. Do you want to play
3 football? Because if you want to play football then we’ll play offside.” It is that easy. Of
4 course, at the moment playing football or cricket with the Australians I am confident that
5 England would win either sport, but perhaps we are not here to decide that.

6 Yesterday Mr. Thompson suggested that one of the reasons why we were not entitled
7 to play rule books with Albion is because we ourselves mixed them, that is wrong, and perhaps
8 the best way to show how wrong it is is to look at the defence bundle at p.38 – this is the tab
9 that contains all of the correspondence. That sets out in Albion’s language a breakdown of the
10 price that we had provisionally set.

11 THE PRESIDENT: Page?

12 MR. TUPPER: Page 38.

13 THE PRESIDENT: Yes.

14 MR. TUPPER: It is probably not worthy of much more scrutiny except, you can if the Tribunal can
15 accept my summary; there is no mention in here, at all, of the value of the water put into the
16 system. This is the actual accounting cost methodology broken down by Albion. As regards
17 these two sources we never attempted to mix the two. We will come back to further evidence
18 where that is, contemporaneous evidence where that is made absolutely clear. So I am hoping
19 that providing that colourful metaphor the Tribunal can understand why it is “just not cricket”
20 for them to attempt to mix and muddle as regards their methodologies. To the extent that there
21 is another mythology that needs to be nailed, it is that we have provided a single access price.
22 Indeed, Albion would have this Tribunal believe that we had an access price and then after our
23 arms were twisted so hard they snapped, we agreed to halve the access price, ergo Albion
24 argues the first access price, the provisional one must *per se* have been excessive. However, if
25 you look at the amended Notice of Appeal at para.49 you will see that, at least in the early
26 stages of this Appeal Albion clearly understood that we were actually providing them with two
27 access prices.

28 THE PRESIDENT: I do not think that is in dispute, Mr. Tupper, that there was a standard tariff and
29 a large user tariff.

30 MR. TUPPER: I think to the extent that I am making this point it is to try and cover off what is
31 contained in the Albion skeleton, which is as I have suggested a sort of crude syllogism that if
32 you have a 27p price and it goes down to 13.6p, the 27p price must, on its face, as night
33 follows day, be excessive. We have never withdrawn the 27p price. That price would apply
34 using that methodology to the extent that they have a standard customer. Their customer list

1 ahs obviously shifted, moved, we are not entirely sure what their customer list is at the
2 moment, but depending upon the type of customer a different access price would apply.

3 This is not something that we have plucked out of the air, this is something that
4 needed to be carefully thought about by all of those involved. If one looks at this in the
5 historical context at the time that this application was being put to Thames, the amount of
6 learning as regards access pricing for water infrastructure in this country was zero, in the
7 world, zero – no one knew exactly how these things should be done.

8 THE PRESIDENT: Yes.

9 PROFESSOR PICKERING: Are you suggesting, Mr. Tupper, that the 13.6 large user access price
10 was on the table from the same time that the 27p was offered?

11 MR. TUPPER: Given the provisional question that we were asked by Albion we provided a
12 provisional quote as regards the access price. At the time that we provided that quote Albion
13 were less than specific as to exactly what they wanted the water for and for whom – not what
14 they wanted the water for, but what they wanted the infrastructure for and for whom. It did
15 come out eventually through the discussions that some of their customers may meet the
16 requirement of large users, at that point there was a discussion as to whether or not therefore
17 we could adjust our price to take it down to the fact that we had different prices and different
18 costs, etc. associated with large users. However, the point of principle that we were concerned
19 about was that whereas for the large user tariff, as regards our water supply to such large users,
20 it was clear – absolutely clear – that our molecules were going down our motorways, down our
21 trunks to those large users, and therefore using up less cost – at least theoretically.
22 Theoretically, however, molecules coming from another source, provided by another supplier,
23 going into our system, would not necessarily only use our trunks. So, what we said is, “Look!
24 Hold it, Albion! It’s a good point, but we need to talk this through with the Director-General
25 because this is an important issue for the whole country in terms of how common carriage
26 access pricing is going to work”. I see that if we go to ----

27 THE PRESIDENT: Are most of your large users on the large user tariff, Mr. Tupper?

28 MR. TUPPER: I believe it is almost as if if you hit certain thresholds and certain criteria in terms of
29 volumetric use you automatically will get the large user tariff. I think that there are certain
30 special prices that are set in certain circumstances, but all of those need to be blessed by the
31 Director-General in a separate process and procedure. But, I think large users get the large user
32 tariff.

33 PROFESSOR PICKERING: As from when?

1 MR. TUPPER: I believe that that system has been in place ---- It has not been in place, obviously,
2 since the beginning of the privatised water sector, but I believe it was accepted that there was
3 a cost differentiation to be made between large users and ordinary users on the basis of the
4 utility of the infrastructure. But, I am just going to turn, if I may, to my own bench and see
5 whether or not I am speaking ---- (After a pause): In terms of there being a small adjustment
6 to what I may have said before ---- what I have said before ---- Apparently, at the outset we did
7 have an idea of the customer list. However, as is stated in the contemporaneous
8 documentation, we needed to talk to the Director-General, and we made that absolutely clear:
9 “Before we can give you the same cost allocation as we give to just general large users, we
10 need to check with the Director-General whether or not that is the sensible way for us to be
11 proceeding, given the fact that it is not quite so clear for us”. But, if I may, this is not an
12 extraordinary situation to be in, given that there was no guidance of any real description
13 available at the time

14 PROFESSOR PICKERING: Mr. Tupper, I think it is important to pursue this. I would like chapter
15 and verse, if you can give it to me, please, as to where you gave any indication to Albion that
16 there was the prospect of considering large user tariff, given that you were aware of their
17 potential customer list, and I would also like to know where the fact of an existence of a large
18 user access tariff from, I think you said, the mid-1990s was actually publicised, because I think
19 what we have got in the paperwork is that if OFWAT had not intervened, apparently fairly
20 robustly, then you would have persisted with the 27 pence, and no variation on that.

21 MR. TUPPER: I am not sure about chapter and verse, Professor Pickering, but let me see if I can
22 give you at least a partial answer, if I may.

23 In January, we have a letter. If you go to Tab 3 of the defence bundle, at p.56 ----
24 Again, this is a personal view, but I think that this perhaps should give you a flavour of where
25 we had got to in this conversation. If you look at 1.2 – the large user discount – AWL has
26 highlighted a significant issue for the industry as a whole. This is to do with the large user
27 discount. “Thames Water views this as a matter that needs to be addressed by OFWAT and
28 DETR will be happy to participate in multi-lateral discussions with other water companies and
29 the relevant authorities.”

30 PROFESSOR PICKERING: It does not suggest you had already got one in existence then, did it?

31 MR. TUPPER: But the large user tariff – if I may be so bold – was in existence. It existed for large
32 users. What was not in existence was any concession for those looking to use the
33 infrastructure. So, as regards common carriage arrangements, there had been next to discussion

1 as to whether or not it would be appropriate. But, I must emphasise this pre-history stage. This
2 is shortly after the primordial soup that we have this application.

3 THE PRESIDENT: Yes. We have got that point.

4 MR. TUPPER: The other thing which is important as regards the price which I would like to
5 emphasise – and, again, we will need to come back to this in two different respects ---- Again,
6 these numbers were not plucked from thin air. They are published. They are available. If you
7 go, again, to the same bundle at p.271 you will see that OFWAT conducted an examination – a
8 full accounting examination – of the numbers that were provided. Based on that full forensic
9 said it said that Thames had not deviated either from the methodology or from the published
10 numbers as regards the actual accounting costs that relate to its infrastructure.

11 THE PRESIDENT: So, they were able to give Mr. Jeffery the reassurance that he sought.

12 MR. TUPPER: If I may, because I would like just to go back to this infamous chart at para. 49, p.17
13 of the Amended Notice of Appeal. We had a discussion earlier today about these columns.
14 Apart from the fact that it makes it clear that no arms were twisted and no prices were halved,
15 the grey part of the column is based, as Albion have suggested, on LRMC – long run marginal
16 costs. Now, I do not suggest that it would be healthy for us to get into the necromancy that is,
17 “Are there LRMC in the water industry?” It is, however, an inexact science that requires water
18 companies to project forwards thirty years, and estimate, roughly speaking, what its costs of
19 resources might be. It is not just about the costs of resources. It is also about supply and
20 demand: how do you control the demand? It is about metering. It is a host of things. To
21 describe it as a crystal ball actually would be to be unfair to crystal balls. To the extent that
22 there is a debate in the water industry – and there has been for some time – it is over, “Exactly
23 how does one calculate?” As many economists as there are in the water industry, there are
24 views. LRMC is nothing more than a guesstimate. However, in exactly the same place as you
25 will find the accounting costs for the costs for the infrastructure, you will find an actual
26 number for the costs of treatment and resource, and that actual number – that real number –
27 would reduce that column that they have put in dramatically.

28 THE PRESIDENT: So, if you took an accounting cost it would be significantly lower than the ----

29 MR. TUPPER: Significantly lower.

30 THE PRESIDENT: -- forecast estimated/guestimated LRMC.

31 MR. TUPPER: Correct. Correct. So, no halving of the costs. An issue that was raised yesterday by
32 Professor Pickering was this issue concerning an indicative price.

33 If we turn to Tab 3 of the defence bundle, and look at p.2, this is the first kick of the
34 ball in this particular dispute – the first kick of the ball which sets the entire agenda. It states in

1 clear terms, “I asked for an indicative price for network access”. In our skeleton we have gone
2 on and expanded upon that theme at para. 36. We have highlighted all of the occasions – at
3 least on paper – where it was made absolutely clear to Albion – and, indeed, Albion made it
4 absolutely clear to us – that all we were doing in the first instance was giving them an
5 indicative price. I go back to the pre-history. I refer to our skeleton at para. 29 which explains
6 how anti-diluvium all of this was. The punch line, as I am sure the Tribunal is expecting, is
7 that the Tribunal is being asked to make a decision that when we suggested an indicative price,
8 we had provided something which is actionable under s.18. If that is true, then competition
9 law, as I understand it, will have changed completely. Remove the possibility of dominant
10 companies negotiating an appropriate price. Remove the possibility of an enforcement body
11 going to a dominant undertaking and saying to the dominant undertaking, “This indicative
12 price that you have suggested is wrong. Can you change it?” If what is being said is that that
13 indicative price will hang like a millstone around the neck of dominant companies, then
14 dominant companies will shut up shop. They will not speak to anyone. They will say nothing,
15 because they will realise that every time they say something, apparently it is actionable.

16 Another mythology is one that has been said before, but I truly believe it is
17 one that needs to be said again. This is a document that is probably more fun than any
18 other – defence bundle at p.151. That last paragraph which, again, has been recited
19 many, many times. As regards the key component of its case, which is set out at the
20 top of the list when it comes round to the benefit of the water, i.e. that we needed to
21 give them credit for the excess over their customer demand. We said, “Yes, we will
22 negotiate that”. Separate agreement. I quote, “If ELL has a predictable consistent
23 surplus of water available, we will be happy to discuss with them options to purchase
24 this as a separate negotiation. No mixing. Separate negotiation, but based upon some
25 kind of certainty as to what it is that we would be buying”.

26 It is difficult to imagine, as the Tribunal, I am sure, has already surmised, how anyone can be
27 guilty of an infringement of s.18 if they have basically said that they are happy to discuss.

28 So, the mythologies have been dealt with. Let us get to what I consider to be the sole
29 bright penny of the Albion case. So, why can it not get credit for the totality of the water?
30 That is all we are talking about now – just this totality issue. Everything else, I believe, I have
31 dealt with completely. So, let us leave aside the fact that as regards the totality of the water,
32 they are in the wrong rule book. Let us leave that aside, because that, in and of itself, is
33 enough to take care of whether or not they should get any credit. There are a number of other
34 issues that need to be considered, and one which I think I will start with, which is a basic issue

1 of policy and philosophy, because it is one, again, the Tribunal will need to grapple with ----
2 What Albion is saying is that a dominant company must buy whatever is delivered to its
3 doorstep, regardless of the circumstances of current needs; regardless of anything – because
4 they are dominant company. That is the proposition that they have presented. I think that it is
5 an important proposition to remember because I am not aware of a single shred of competition
6 law that could possibly substantiate such a position, because it would, again, change
7 completely competition law as it applies to dominant undertakings.

8 At this point, I think it is important for me to try and see if I can deal with the
9 desalination plant. What I am going to do is hope there will be some chirruping from behind
10 that will correct me if I have got some of the facts wrong. The desalination plant is scheduled
11 to get final approval at some point in the near future. There is apparently a meeting today with
12 the Mayor of London to consider certain environmental issues. Those environmental issues
13 follow the tack which apparently the Mayor is taking that to the extent that a desalination plant
14 might lead to the drowning of a single Bangladeshi, he will have nothing to do with it. He is
15 concerned about energy use; he is concerned about greenhouse gases. However, eventually the
16 desalination plant will provide 110 megalitres a day of water. The idea is that the desalination
17 plant will be there to take care of the rare circumstance where this particular water supply area
18 is in deficit. The last time that took place was fourteen years ago. However, there is a
19 possibility that this year – maybe another. But, to put it into perspective, in terms of our
20 deficit need, let us work on the basis of once every fourteen years. But, in order to cover off
21 the deficit needs, 110 megalitres per day is probably what we are looking for in terms of ready
22 capacity that can be turned on to deal with it.

23 Now, I am not sure whether or not the Tribunal has any questions with regards to the
24 desalination plant, but an issue which does arise out of the desalination plant is one which
25 comes from a comment which was made by the Tribunal today – and that is, “Surely, when the
26 water gets put into the system, it stays in the system”. That is not entirely correct because the
27 system can only store a certain number of litres. When you get to the top of the reservoir, you
28 have to start pumping it away. So, it does not just stay in the system. Eventually it will get
29 put back into the River Thames, but there is only so much we can actually deal with. So, it is
30 not as if that when the water goes into the system we can just, with a bucket, dip in, take it
31 whenever we need it, etc. It disappears – it disappears in the sense that it will slop over the
32 side of the reservoir; but it disappears in a number of other ways, and I think it is important to
33 bear that in mind.

1 PROFESSOR PICKERING: Since you asked, Mr. Tucker, I do have a question on the desalination
2 plant, because I think what you have just said is slightly contrary to Mr. Turner's comment this
3 morning. Mr. Turner indicated that he understood that once it was operational, that it would
4 contribute to the baseline requirements. You have now indicated that it would only be called
5 into play when there was a water deficit.

6 MR. TUPPER: I am hoping that whilst I have been pontificating that the team has been trying to
7 work out the necessary rise of demand that is happening within the south-east area, and in
8 particular in the Inner London area, but clearly in addition to the need to cover off what is
9 known as the "headroom issue", to cover off the gap between a very, very dry year and the
10 capacity of the system to actually hit that gap. The desalination plant is the key initiative that
11 Thames is putting forward in order to get this resolved.

12 THE PRESIDENT: Professor Pickering's question is is it just for that or is it for other ----

13 MR. TUPPER: As I understand, I am hoping that if I look around now, someone is going to nod
14 furiously, but the desalination point will also take up the increase in demand, or part of the
15 increase in demand that is projected for the London area over the next five years.

16 MR. TURNER: I should just say I did not have any firm understanding on the point and I defer to
17 Thames on this.

18 MR. TUPPER: I believe I have it right, but I expect my coat to be tugged if I do not.

19 THE PRESIDENT: I think, Mr. Tupper, if we need more specific information about the desalination
20 plant it is probably easiest for us to write to you and ask for it than try to deal with it on the
21 hoof.

22 MR. TUPPER: Yes.

23 THE PRESIDENT: Can I just ask, there is a certain amount in the Notice of Appeal that says first of
24 all that the ground water in London is tending to rise, is that common ground as far as Thames
25 is concerned? Is that something it accepted that there is a rising ground water level?

26 MR. TUPPER: I believe that is accepted by Thames.

27 THE PRESIDENT: Thank you, very well, let us press on. I do not want to hurry you, but I do not
28 want to slow you down either, if I may drop an appropriate hint.

29 MR. TUPPER: If I may I would just, very quickly, like to deal with the ground water issue, because
30 I think another thing which Thames is entitled to do is to choose its sources carefully. I will
31 give you another example, and it is one which I feel I have to do because my client suggested it
32 is a good example, and so on. If Albion were to tug an iceberg to London and say "Here's an
33 iceberg, it's going to cost you 5 billion, please use it for fresh water purposes", we would have

1 to look at them and say “We didn’t really want an iceberg”. That isn’t exactly the kind of
2 source that we need”.

3 Likewise, when looking at boreholes and ground water there are alternatives, and we
4 obviously need to choose carefully as to which sources we think are the right sources to
5 choose, given our needs and our commercial profiles, etc.

6 One of the key issues that has not been addressed, and it is one again that came up this
7 morning, is the supply of last resort issue. We were asked by Albion to provide that as a
8 service. It is, in fact, part of their own statutory requirements; they need to make sure there is
9 someone that backs them up to the extent that their source falls over. They asked us to provide
10 that service and, indeed, we costed it for them on a provisional basis. If, in such circumstances
11 we are to provide that service, we do not get to turn off any of our taps. We do not get to close
12 down any of our sources. Those sources must still be available to the extent that they may fail
13 and the Tribunal will remember that as regards Hammersmith Hospital boreholes can fail.
14 Yesterday I believe you asked for pricing information, billing information concerning
15 Hammersmith Hospital which I have available, which I am more than happy to distribute to the
16 court. It will make it clear that since the time that Hammersmith Hospital came on line with its
17 borehole I think it is probably fair to say the borehole has supplied only one-third of the
18 supply. So one-third of the supply has come from the borehole, the remainder has come
19 straight from the mains. So if the Albion argument is to work, i.e. there is some benefit to us, I
20 struggle to see where we are going to realise that benefit if we are providing that service.

21 I am more than happy to explain the chart if ----

22 THE PRESIDENT: No, that is all right, thank you.

23 MR. TUPPER: I recognise the time, I will just hit very briefly two points. Mr. President, you have
24 made the point, and indeed Mr. Turner has made the point, that competition law is about level
25 playing fields, and not about tilting in one direction or the other. To the extent that they get
26 full value for this water then the playing field would certainly tip in favour of the new entrant
27 in a way which we would consider to be inappropriate, and Professor Pickering, you did
28 suggest why do you not just modulate your supply? This is something we suggested to Albion
29 and they said “No, no, we just want to pump all the water we can, whether you like it or not,
30 whether you want it or not, it is going into your system.” Not necessarily the kind of way that
31 we would have approached such an initiative.

32 In summary, Albion has listened but it has never heard. Albion prefers “war-war” to
33 “jaw-jaw”, that has been clear from the outset – shoot first and do not worry about any of the

1 ramifications. It has become like a bit of a grand obsession – a man in search of Eldorado.
2 But these two boreholes do not have any gold, they just have water, that is all they have.

3 This Appeal should be dismissed.

4 THE PRESIDENT: Thank you, Mr. Tupper, can you just help me on one point? Mr. Pittaway in his
5 evidence, and elsewhere in his documents, there is quite a lot of argumentation which is to the
6 general effect that this sort of operation really saves us nothing because we have to keep the
7 back up supplies, we cannot defer future capital expenditure, it does not free up any resources,
8 mucks up the system, etc. – all those things I summarise rather brutally probably – which is a
9 very detailed argument. Can you imagine for us, or paint a picture in which you could
10 envisage a new entrant coming in that would enable you, as you put it, after a suitable “jaw-
11 jaw” arrive at a reasonable deal which would both facilitate new entry and meet whatever
12 statutory difficulties and logistical and operational difficulties you may have? Or is the logic
13 basically, of your argument, that for, as you would say, various very good reasons most of this
14 is really a non-starter and it is never going to work because we are always going to have to
15 provide the back up and we will never really save any money in any circumstances we can
16 realistically imagine?

17 MR. TUPPER: I believe I have the answer but I am afraid I am going to have to refer the Tribunal
18 one more time – perhaps the last time – to p.151A of the defence bundle, and in particular
19 subparagraph 3, which is right at the top, it is parentheses 3.

20 “We would not see it as appropriate to reflect in an access price possible benefits of
21 any available water...”

22 this is because of the accounting costs –

23 “... the intermittent and unpredictable nature of sporadic surpluses would make it impossible
24 to value. As described above, if reliable, consistent surplus is available, we would be happy to
25 discuss this as a separate commercial item.”

26 THE PRESIDENT: I see, so in principle if there is a ----

27 MR. TUPPER: If I may be so bold, and I am sure that this is not going to be appreciated to the right
28 of me, but one way that Albion could have approached this is to say “Okay, we can understand
29 why you are hesitant to pay money for what may turn out to be nothing at all. So why do we
30 not enter into an access arrangement and have a period of retrospection? Let us work it for
31 three years? After two or three years we can look back at the history of supply and if we can
32 demonstrate to you that it was both reliable and consistent, then you, Thames, should pay for
33 that retrospective analysis and then also pay for the future based on that reliable information.”
34 That could have been done, and it could have been done two years ago. If it had been done

1 then obviously there is scenario where more boreholes could be brought on stream, either by
2 Albion or by others. But it has to be as a matter of policy, as a matter of law and
3 commonsense, based upon real, reliable performance and consistency ----

4 THE PRESIDENT: It is the reliability of the information that you are ----

5 MR. TUPPER: And the reliability of the source etc.

6 THE PRESIDENT: Yes, I see.

7 MR. TUPPER: There are many scenarios where Thames needs the water. Thames accepts that it
8 needs the water, but it cannot just take virtual water. It must pay for real water consistently
9 and reliably supplied.

10 THE PRESIDENT: Right, thank you very much.

11 MR. TURNER: Before Mr. Thompson starts, I have a point of factual clarification. I think Mr.
12 Tupper may have been a little bit hard on himself when saying that Thames did not initially
13 offer a lower price for the large user tariff, and it is because Professor Pickering said it was
14 important. The references are the letter of 21st September 2001, which is p.150, tab 3, bundle
15 3, point 5.1, in which you see the real dispute was they said that where customers would enjoy
16 the large user tariff, they would give them a 27 per cent. discount. Do you see that?

17 PROFESSOR PICKERING: Sorry, is this 150A.

18 MR. TURNER: 151.

19 THE PRESIDENT: We have 151 and 151A.

20 MR. TURNER: 151.51. You will see what was actually being suggested, you see what I mean they
21 were offering a discount. What happens is Ofwat takes issue with that and say "It is not good
22 enough", and it does that in the letter at p.172, and forces them down. So merely as a point of
23 factual clarification that is how it arose.

24 MR. TUPPER: I do have a very brief response to the question concerning demand, but I am happy
25 to do it by way of correspondence if you would prefer.

26 THE PRESIDENT: It is very often worth just checking that everything is completely reliable
27 because answers given on the hoof are often useful but sometimes there is a qualification or a
28 further fact or something.

29 MR. TUPPER: We are more than happy ----

30 THE PRESIDENT: No, just let us have it in writing, I think. Mr. Thompson, we are just going to
31 rise for a few minutes before you kick off.

32 (Short break)

1 MR. THOMPSON: Good afternoon, Sir. It is always slightly disadvantageous to be put into bat at
2 this stage of the day. I will try and make a coherent presentation, but I am sure the Tribunal
3 will bear with me if I hop about in all the circumstances.

4 THE PRESIDENT: We would like to finish today, I think, Mr. Thompson.

5 MR. THOMPSON: Yes, indeed. If I may take, first of all, I think Mr. Tupper said there was only
6 one issue in this case. We say that there are plainly two issues in this case. The first one
7 relates to the 27p price and I would like to make it clear that this is not a challenge to average
8 accounting costs, and therefore as we understood it, Mr. Turner's submissions on this issue
9 were essentially irrelevant. As Mr. Tupper puts it we have no objection to average accounting
10 costs in themselves, but we say they must be done properly and fairly. Our challenge, a
11 challenge to a non-infringement decision in relation to the 27p per metre cubed price, we do
12 not understand Mr. Turner to have made any points in substance to defend the position of the
13 Director that this was not an infringement of the Chapter II prohibition. The price was twice as
14 high as the Director had ultimately approved, and constituted a price squeeze on any
15 reasonable view as to the price of the resources.

16 You were shown in some detail the documentary history of this matter, but the key
17 letter in relation to this was not shown to you by Mr. Turner, and I would just like to take you
18 back to it because it is obviously crucial. That is bundle 3, tab 3, pages 165-166. The
19 Director's analysis is at p.166 and this is responding to effectively an offer from Thames,
20 which I think Mr. Turner showed you, which appeared at p.151, to which the Director, or
21 Ofwat, made a detailed calculation which appears in the paragraph starting: "In terms of prices
22 for 2001", etc., and concludes with the 13.6p figure in the penultimate line. They then say:

23 "To avoid any accusation of anti-competitive behaviour and to maintain a revenue
24 neutral approach we would expect the same approach to apply in respect of very large
25 users."

26 Then it goes on:

27 "Incidentally we note that Thames's cost analysis of 22nd November 2000 supporting
28 its large and very large user tariffs for 2001/2002 would result in even greater pence
29 per metre cubed differentials."

30 So what they are saying there is that you would apply the conventional average accounting cost
31 approach to this issue, the extent of excessive pricing would have been even greater. So the
32 suggestion that we are in some way inconsistent with average accounting cost principles, or
33 attacking average accounting cost is simply a bad point.

1 THE PRESIDENT: Are you able to throw light on the next sentence: “This is an important issue
2 which will apply within the ECPR approach as it does within the accounting costs approach”.
3 What is the important issue in there?

4 MR. THOMPSON: I suspect it is that they should be consistent in their approach. We are obviously
5 at a disadvantage because we do not have the actual numbers, and in this particular Appeal we
6 accept that ECPR was not really on the horizon at the time of the Decisions. But our complaint
7 is that the failure to make a Chapter II decision in this case effectively acted as a green light for
8 the price to go back up again, which it duly did.

9 MR. TURNER: If I can confirm, Mr. Thompson is right about that as far as we can tell. The pence
10 per cubic metre approach is what was apparently being discussed there.

11 THE PRESIDENT: Yes.

12 MR. THOMPSON: In relation to resources, Mr. Turner sought to make a forensic point about the
13 negative figure that appears in the late 2001 to show that our position is unreasonable. The
14 Tribunal will recall that our point was not – and never has been – that a specific reduction
15 should be made, but that a reduction of zero is unacceptable for a monopolist in an area of
16 resource deficit and that a reduction of zero is a clear abuse. What the correct reduction figure
17 is is not a matter with which the Tribunal needs to concern itself, and I would accept in effect
18 that this was a negotiating position of Albion rather than its final position as
19 to the only figure that it was prepared to accept ----

20 THE PRESIDENT: What document are you talking about now, Mr. Thompson?

21 MR. THOMPSON: You may recall a document, if I can find it ----

22 THE PRESIDENT: Somewhere in the 160s, is it? Were you talking about 168?

23 MR. THOMPSON: Page 168. I showed it to you in the other bundle. That figure is obviously a
24 low figure which is achieved by deducting 45 pence from the 27 pence – so, as it were, giving
25 full credit for the water ---- for all the water in relation to the water carried. There are
26 obviously various considerations about what the correct figure should be. For present purposes,
27 the only point we are making is that it should not be zero, and you will recall that Thames
28 itself, and the Director, said that the minimum figure would be in the region of 3 pence,
29 reflecting reduced pumping and chemical costs. We merely say that zero is the wrong figure.

30 I should say that we say that the fact that this is an area of deficit is crucial. Were this
31 water being pumped into the Elham Valley, for example, so that it was merely washing away -
32 or, indeed, into the Thames, and so it was simply going out into the Thames Estuary – then the
33 point would obviously not be a forceful one. The fact that that it is being put into an area of

1 supply deficit – and, indeed, a sensitive area of supply deficit – is obviously crucial to this
2 point.

3 THE PRESIDENT: What do you say that the relevant area is? Is it the Thames area? Is it the water
4 zones that we are dealing with here – one was Bethnal Green, I think; the other was Mile End?
5 Is it a wider area than that? Or, what is it?

6 MR. THOMPSON: I was proposing to come on to this when we come to the question of symmetry,
7 which is whether or not zero is a symmetrical figure for the amount that we are charged. In his
8 submissions today, slightly to our surprise, Mr. Turner revived what was, in effect, a sort of
9 half-hearted strike-out in relation to, I think, two issues – margin squeeze and the whole supply
10 issue. I say we were surprised because it seemed to us that if the issue was going to be raised,
11 it should have been raised yesterday.

12 In relation to margin squeeze, I think you have my submissions already. We say that
13 the excessive pricing abuse and the lack of margin are effectively two sides of the same coin,
14 and that the substance was raised not only in the original complaint, as reflected in the
15 summary notice when this was originally published, but also the substance was raised in the
16 April 2003 letter where you will recall that Dr. Bryan complains that the effect of the excessive
17 pricing was to make it impossible to enter. We say that for a layman that is clearly good
18 enough for a price squeeze allegation.

19 In relation to whole supply, I think Mr. Turner went so far as to say that that issue had
20 never been raised. That is not correct, as I will show you if we look briefly at the letters. The
21 relevant letter is 21 March, 2002 letter. I find it easier to operate in the Albion bundles. I do
22 not know if that is inconvenient. If not, we can no doubt turn through Bundle 3, Tab 3 and find
23 the letter.

24 THE PRESIDENT: What date is it? 21 March you said?

25 MR. THOMPSON: 21 March, 2002. It is p.191 in Bundle 3, Tab 3. You will see the first
26 paragraph – Mr. Jeffery is complaining about the closure, and he is saying, “I would welcome
27 feedback from your consideration of the points raised in my letter of 28 January, 2002 to Mr.
28 Chant of Thames (copy to you) and 5 December, 2001, addressed to you”. Then, over the
29 page, under Complaint 2, at the end of the second paragraph he says, “We still have not
30 received a response from Thames Water to our letters of 14th and 28 January, both of which
31 were copied to OFWAT”.

32 If one then turns back to what those letters were about, you will find the letter of 28
33 January, 2002 at p.181. At p.182 you will see that this was a letter from Mr. Jeffery copied to
34 Beryl Brown at OFWAT. There are two issues . At para. 4 you will see ‘Demand and Supply

1 Match.’ “You indicate you expect an entrant to match the demand profile of its customers. As
2 previously advised, we would expect to match the annual demand from customers to input at a
3 constant rate”. So, that is the issue about balancing. Then, at 5, “Reciprocal financial
4 arrangements on overs and unders. I believe a lack of reciprocity in your company’s position
5 is not consistent with OFWAT draft guidelines, and may therefore breach the provisions of the
6 Competition Act 1998”. At 7, “Benefit accruing to Thames in relation to supply/demand
7 balance, and where the London areas are in deficit, I believe there should be some financial
8 recognition of the benefit of the new source to Thames in terms of capital deferred or ability to
9 use its own resources elsewhere, or to meet its own service obligations”. So, that point was
10 indeed raised with Thames, and thus with the Director.

11 The complaint that Mr. Jeffery was making was that the five bullet points which
12 eventually emerged were essentially the Director’s creation, and that there were a number of
13 other points, including this one, which were still unresolved. The response of OFWAT to that
14 was the rather peremptory letter of which we complain, which is at p.194, where Miss Cooper
15 appears to have run out of steam on this complaint. She says that they are going to “ -- close
16 the file by 22 March unless you respond with relevant information which would justify further
17 work. Your letter does not do this. You suggest your remaining concerns can be addressed
18 outside the formal complaints process. I agree. Therefore we have closed the Competition Act
19 1998 file”. You will appreciate that that was not what Mr. Jeffery had been saying. He had
20 been saying, “Can we meet to discuss how to take this forward?” and essentially she just slams
21 down the ‘phone and says, “That is the end of that”.

22 So, it is not true that there was no complaint about the failure to give credit for supply
23 not limited to the surplus.

24 THE PRESIDENT: The point you have just made about the letter of 28 January, 2002 is not actually
25 picked up again in Mr. Jeffery’s letter of 21 March, 2002; is that right?

26 MR. THOMPSON: I am sorry. It is picked up because there has been no response to those points.

27 That is one of his complaints – both in the introductory paragraph, and under Complaint 2.

28 THE PRESIDENT: I see. Yes.

29 MR. THOMPSON: Likewise, on p.192 he says, “We still haven’t received a response from Thames
30 to our letters of 14 and 28 January, both copied to OFWAT”. So, those points have in fact been
31 raised and included by reference in that letter.

32 PROFESSOR PICKERING: Are you going to show us p.197 and 198, and 199 where I would have
33 thought that Mr. Jeffery, having taken the initiative to continue the conversation and suggested

1 that some of the matters were not specifically Competition Act complaint issues, does rather
2 continue the debate, does he not?

3 MR. THOMPSON: Yes, it does. I should perhaps remind the Tribunal that there is a statement from
4 Mr. Jeffery appended to our reply where he deposes to this issue, which is Tab 2 to our reply
5 bundle. He deposes to this issue at paras. 11 and 12. I think the relevant part in relation to
6 this issue is towards the second half of para. 12 on p.3. He says,

7 “In addition, my recollection is the discussions on over and under-supply were less
8 clear-cut than the note of the record implies. I indicated I wanted to continue to press
9 our case on this matter, but acknowledged that I would have to do so outside of the
10 complaint as OFWAT had effectively closed off that avenue. I also indicated I
11 understood the points that OFWAT were making on costs and benefits, but not that I
12 agreed with them, which I do not. Indeed, the views expressed in the note portray
13 OFWAT’s lack of understanding on the issues and are addressed in the main body of
14 Albion’s reply. In this context it was not possible for me to advance further argument
15 without going outside the remit of the conversation to which OFWAT insisted on at
16 the hearing”.

17 So, that is Mr. Jeffery’s recollection of the matter.

18 My general submission on this part of the case – I think Mr. Turner recognised, as it
19 were, the layman point that we make – that this was a matter that was being conducted by
20 laymen. I would also add to that submission that this was in fact the first decision, or non-
21 decision, that I think the Director ever took under the Competition Act, and so it was an area
22 where my clients were feeling their way, and, in my submission, the level of detail and rigour
23 that they submit is in fact of a pretty high order, which would not have done any dis-service to
24 an experienced solicitor. But, insofar as the intervener, or Mr. Turner, seek to effectively trip
25 up my clients by saying, “Ah! But they didn’t raise this question in quite the right form”, that
26 is, in my submission, a very harsh way of putting it.

27 I would, in fact, remind the Tribunal that what actually happened was that the
28 Director invited my clients to put forward complaints by reference to the five points contained
29 in the decision letters. We did that in the April 2003 letter. I think it is probably worth
30 reminding the Tribunal what happened then, which is that on 1 May, 2003 (and one finds this
31 at p.250 of the same tab), Miss Brown writes to Dr. Bryan and says, “We are considering your
32 s.47 application, and we will advise you on progress when we are in a position to do so”.
33 What actually happened then was absolutely nothing whatsoever. All that happened was that,
34 in fact, a decision was taken without further reference to my clients, and when Dr. Bryan raised

1 the point in his application in the Shotton case, he received a letter effectively saying it was
2 none of his business. We find that – again, I am less familiar with this bundle than with the
3 other one – at p.280. It is a letter dated 28 April, 2004. There is reference to the Shotton
4 application. Then there is an assumed reference to Bathhouse. Then, in the next paragraph,
5 “Section 47 applications were made by Peninsula Water. Therefore we will only respond to
6 Peninsula Water ----“

7 THE PRESIDENT: There was a skirmish ----

8 MR. THOMPSON: “—We will not be corresponding with Albion Water about them.” So, in my
9 submission, to take almost a year where they did nothing, and then the only response, after the
10 decision had actually been taken, was to say that OFWAT was not actually going to
11 correspond with Albion at all ---- It would extremely unattractive for the Director to take any
12 very robust procedural point about my client’s failure to pursue its remedies more
13 comprehensively in the s.47 procedure.

14 If I can come now to the question of the supply deficit and regulatory approval, Mr.
15 Tupper said that there were basically some rather strict rule books in this case, and that the
16 only two in town, effectively, are AAC and ECPR. My clients operate on a simpler rule book,
17 which is that particularly monopolists should pay for benefits, but they should act consistently,
18 and they should comply with the Chapter II prohibition. In this particular context, we further
19 say that they should comply with the principle of symmetry which was recognised by the
20 Director and explained to the Tribunal this morning. We say that, here, there was no symmetry
21 in relation to the methodology, even though there is a supply deficit. No credit was given at all
22 to the water inputted by my clients. If average accounting and long range marginal costs are
23 the right basis for the costs of Thames, then there is no obvious reason why an average
24 accounting approach should not be adopted in relation to market entrants - so that one would
25 look at the average saving to Thames, and not at specific savings relating to boreholes. In this
26 respect we note the concession made by Mr. Turner that he did, in fact, not investigate ---- or,
27 the Director did not in fact investigate what the actual position was here, but merely took
28 Thames as the incumbent monopolist’s somewhat self-serving criticisms of the viability of the
29 project.

30 THE PRESIDENT: So, when you say ‘average savings to Thames’ you mean that what they should
31 have done is have some calculation that somebody will have made at some point which says
32 that. “In general, it saves us so much if we have to supply so many litres less”, and simply
33 apply that to the expected volume that you were going to produce.

34 MR. THOMPSON: Yes. Yes.

1 THE PRESIDENT: And not look at the specific case of the specific borehole, and say, “Well, that’s
2 only a very little borehole. It’s not going to save us anything”.

3 MR. THOMPSON: Quite apart from the intermittent surplus error which we say was made, we say
4 that there was not an intermittent surplus – what there was was a constant input, and an
5 intermittent exit, but that intermittent exit was taking place anyway. So, the benefit was the
6 constant input.

7 THE PRESIDENT: The constant input to the customer, rather than the intermittent surplus that was
8 going into the Thames system because the customer did not want it.

9 MR. THOMPSON: No. It was a constant input into the Thames network.

10 THE PRESIDENT: Right.

11 MR. THOMPSON: What I think it may be helpful to do is to distinguish between the direct and
12 indirect costs of this service, because you will recall that – I think on any view, and certainly
13 on our construction of s.66(e) of the 2003 Act – there are at least two elements: there are the
14 direct costs of supplying the service, and the wider costs which Thames (and other water
15 undertakers) bear as their public service functions – the point which Mr. Turner referred you to
16 by reference to Corbeau. In my submission it is appropriate that at least in relation to the
17 second category - the discharge of public service obligations – that if a constant input is being
18 made into a network which is subject to public service obligations, then credit should be given
19 to the extent that that input relieves, to some degree, the incumbent of the obligation to
20 perform those functions. What I am saying here is that all we need for our case is that zero is
21 plainly the wrong number, and we say that the precise figure, the sort of credit that should be
22 given, raises the sort of issues which the Director is apparently grappling with in his 2004
23 guidance. So you look at the direct costs, you look at the reductions in leakage and you look at
24 the deferred capital and expenditure and it is precisely those sort of points that were being
25 raised by Mr. Jeffrey in his 28th January 2002 letter, but which Ofwat did not consider in its
26 Decision letters at all and which we are now trying to get back as a point of principle, because
27 we regard it as a matter of important principle, both as fairness and in terms of commercial
28 reality in this market.

29 THE PRESIDENT: This is now talking about the benefit of the totality of the supply going into the
30 Thames’ system, or just the bit that is left over beyond what the customer needs at any time?

31 MR. THOMPSON: We say in principle all the water is a benefit. Insofar as some of the water is
32 taken out obviously there is a question about the fact that my client is receiving money from an
33 end consumer as to whether that should reduce the amount that it should recover from Thames,
34 but we are at the level of principle that we should receive something from Thames.

1 THE PRESIDENT: The basic answer to that I think is at 277 in **this** bundle, the 1st April letter,
2 where the point that is put against you is that they will not necessarily get a benefit from it.
3 There is no evidence that they will get a benefit, and then Thames's position essentially is, and
4 I think Mr. Tupper confirmed it this afternoon, if there was a predictable and consistent surplus
5 available, then they would be happy to discuss it, to purchase it, but they thought that this was
6 an unpredictable and intermittent input and was going to be more trouble than it was worth,
7 and had it only been consistent, had you only taken up their offer to discuss it, all this could
8 have been avoided, that is what is said.

9 MR. THOMPSON: Yes, I have to say that, the word "disingenuous" is perhaps not a word one
10 wants to hear in this particular forum, but it Thames cannot have been under any
11 misapprehension about what was being proposed, and it was clear that we were not intending
12 to inject water erratically. They give an absurd example of somebody who suddenly pushes
13 huge amounts of water into a reservoir and say they want to be paid for effectively tipping a
14 huge quantity of water into a reservoir. They knew perfectly well that was not what was being
15 proposed here. What was being proposed was a small constant borehole coming into their
16 network, and then the same fluctuating demand that they had been managing anyway or indeed
17 do manage if and when they are required to perform their supplier of last resort obligation. So
18 we say that this point, which the Director apparently fell for, is simply a bad point. The other
19 point I will come to because, in my submission, what Mr. Tupper said was certainly
20 incomplete and misleading in that one of our complaints was that Thames not only required us
21 to input water as far as possible to match the demand of our customers, but that they refused to
22 make any sort of partial supply so that we could not, say, supply half of the hospital's
23 requirement and leave it to Thames to make up the difference, so that we were inevitably, as
24 demand fluctuated going to generate a surplus, because in order to match the maximum
25 demand of our customers we would have to put in at that rate, if they ever dropped below that
26 demand then Thames was going to take water into its system for which it refused to pay, and
27 that is why we thought it was unfair.

28 THE PRESIDENT: Mr. Thompson, what the proposition was, certainly at one stage, was that you
29 would, as it were, balance it out on a monthly basis and I think have some kind of charge or
30 counter charge, financially speaking on a six monthly basis, if I remember rightly. If you are
31 dealing with an institution like a hospital or a university college, or something, over a period of
32 a month or so, presumably you can, roughly speaking predict how much water is going to be
33 used, even though it may vary according to the day or the night, or whenever. There may be
34 different usages at Christmas time, or less in the Summer or more in the holidays or something,

1 I just do not know. But surely it is possible to work out how much water this customer is
2 likely to take over a period.

3 MR. THOMPSON: Oh indeed.

4 THE PRESIDENT: And then work out or agree certain tolerances within which you neither pay
5 them for drawing in a deficit from the main supply system, and they do not pay you for over
6 supply and you only get to charge if you go outside the agreed parameters. In the meantime
7 the pump is there just pumping. Why could that not have been agreed, as it were?

8 MR. THOMPSON: I think that is why we particularly objected to the overs and unders point,
9 because we were required to supply to the maximum demand of our customers, There are
10 going to be fluctuations and so there was going to be a net surplus as the fluctuation went
11 below the maximum, but we were going to be charged if we dropped below for any reason, if
12 the demand went up, but we are going to get no credit if, for some reason, demand went down,
13 and so we thought it was unfair. We still think it is unfair. If I can just show you, p.134 ----

14 THE PRESIDENT: Let me just pursue this. What the letter of 1st April is saying (p.277) there is an
15 agreed balancing period, and they get reconciliation and all the rest of it. "Thames Water say
16 they are outside the margin and after reconciliation it should be paid for water taken from it."

17 MR. THOMPSON: Yes.

18 THE PRESIDENT: "Enviro-Logic had a reliable and continuous supply of water available to it"
19 which you said they had, "It would be happy to discuss with Enviro-Logic options to purchase
20 the surplus".

21 MR. THOMPSON: That is a completely different proposal. That is a proposal for us to act as a bulk
22 supplier of water, which was never our intention. What we wanted to do was, as it were, a
23 variant on our Shotton business; we wanted to act as a retailer of water, but with our own
24 sources.

25 THE PRESIDENT: Right.

26 MR. THOMPSON: If I may just show you, p.134, this is the letter of 8th March, where this matter
27 was first fully discussed. Page 134, 3.8(a):

28 "Thames as the incumbent expects an entrant to supply water into the network to
29 match the demand profile of its customers, and entrants should not supply water into
30 the network that is not required by its customers. Small fluctuations in the daily
31 demands of the entrant's customers would be accommodated by Thames, by their
32 routine operational management of the network."

1 So what we had to do was to match the demand, but they were not in any way saying “Put in a
2 surplus and we will pay you the extra”. If I can just show the Tribunal how Dr. Bryan put it in
3 the complaint letter, which is at p.206. It is the bullet point at the top of p.208:

4 “Thames are not prepared to accept a common carriage agreement on the basis of
5 partial supply to some of Albion’s customers. I expect Albion supply the quantity of
6 water to match the peak demand of Albion’s customers.”

7 So effectively we were stuck with the position we were going to generate surpluses, but we
8 were not going to get any credit for them, and that was one of the points that we took exception
9 to.

10 THE PRESIDENT: Can I just go back to 21st December 2001 – which is where that point is made?

11 MR. TURNER: I believe it is 21st September 2001.

12 THE PRESIDENT: Thank you, Mr. Turner. Yes.

13 MR. THOMPSON: It says “We have asked”, I think it goes back to the passage I have shown you
14 before from 8th March. That was certainly Dr. Bryan’s understanding of the approach and I do
15 not think it is disputed that they were not prepared, as it were, to have any partial supply
16 coming from Thames, except as a supplier of last resort.

17 THE PRESIDENT: Just so that I can understand it, let us assume that there are certain periods of the
18 day, I do not know, when people are getting up or going to bed, or something where there is a
19 peak demand for water for a particular customer, you would have to be pumping enough I not
20 meet that peak demand so that either you pump at different rates from the borehole, or if you
21 pump at constant rates, then you have to be pumping at the rate necessary to meet the
22 maximum demand, which inevitably means that you create surplus water at other times.

23 MR. THOMPSON: I suspect it is not quite as minute to minute as that. I would suspect it is more
24 by reference to whatever is the correct unit, I do not know whether it is a day or a week, but I
25 do not think it is minute by minute, but after all the water is going in one place and coming out
26 somewhere else.

27 THE PRESIDENT: All right, well if we take a more simple example – it is probably not this case –
28 but you imagine an academic institution where people are there five days a week, but there is
29 nobody there at the weekend, or something like that, your case is that you would have to be
30 pumping at the peak rate for most of the time and it either was not economic or practical to
31 adjust the pump rate, so that you were inevitably creating a surplus that would just be going
32 into the Thames’ system, and therefore benefiting them (according to you) but without you
33 getting any remuneration from Thames for that.

34 MR. THOMPSON: Yes, that is the essential shape of the point, yes.

1 THE PRESIDENT: Right.

2 MR. THOMPSON: I think it may be a convenient moment to look at the point about 66J, which Mr.
3 Turner made yesterday, which you may recall was said that there was some sort of criminal
4 offence created of introducing surplus water into the networks. If we just look at that briefly.
5 Tab 15, p.48, section 66J. In my submission this illustrates the rather artificial points that Mr.
6 Turner and Mr. Tupper have made about the brave new world. In my submission the world is
7 not so brave and rather similar issues arise under this legislation as a matter of principle would
8 arise under competition rules generally. Here, the problem is said to be that we cannot put in a
9 surplus but I think Sir Christopher raised the point with Mr. Turner that this is potentially very
10 anomalous in that it appears to be that as soon as your customers' demand drops off you start
11 to commit a criminal offence, and it seems to us that there was no very good answer given to
12 that conundrum. It seems to us that the only answers there are are either a form of regulatory
13 qualification, which this legislation does not appear to make provision for, or for the
14 undertaker such as Thames, to exercise the derogation in 66J(1), so that the undertaker has a
15 free right to introduce water into the system, or for the undertaker to involve itself in partial
16 supplies, because the only way that a client such as mine can avoid committing criminal
17 offences under this legislation is either to enter into a contract with Thames whereby any
18 surplus will be deemed to have been purchased by Thames, or passed into the ownership of
19 Thames before it enters the system, or for Thames to say that it will take a partial supply, for
20 example, half at the hospital, so that we will never put surplus water into the system. It seems
21 to us that it is likely to introduce further obligations on undertakers to facilitate competition,
22 failing which a client in my position would effectively be debarred from entering this market
23 by the risk of committing criminal offences every time that its clients' demand went below its
24 input into the system. In my submission the issues remain live.

25 THE PRESIDENT: Somebody must have thought of this point, surely, Mr. Thompson?

26 MR. THOMPSON: Well I am afraid it is not within my powers, or my client's powers to control
27 this legislation.

28 THE PRESIDENT: No.

29 MR. THOMPSON: If we can then turn to the issue of price, as I have said we are not contesting ----

30 THE PRESIDENT: Before we go on, Mr. Turner, you have been following this part of the
31 discussion?

32 MR. TURNER: Yes.

33 THE PRESIDENT: Did I just then, as it were, correctly identify what the problem was? I am not
34 saying what the answer to the problem is but what they say the problem is. They say the

1 problem is they have to meet the peak demand of the customer, there will inevitably be
2 periods, perhaps days or weeks, or different times, or whatever, when there will inevitably be a
3 surplus, and that they say that they should have some credit for that, to which, as I understand
4 it, the basic answer given by the Director in his letter of 1st April is to rely on the answer in
5 turn given by Thames which basically says two things. One, an intermittent supply is not
6 much use to us – quite the contrary; and two, we are prepared to discuss purchase of the
7 surplus under some separate arrangement?

8 MR. TURNER: The first point certainly does need some qualification. The supply envelope is a
9 very important idea, so it is not necessarily the case at all that they are necessarily going to be
10 falling outside the parameters, the margin of tolerance in what they do. There is a balancing
11 over a period, and there is a margin of tolerance and, in fact

12 *** ... There is a balancing over a period, and there is a margin of tolerance, and, in fact, there is
13 no good reason why they should be consistently injecting a surplus into the network beyond
14 what Thames has stated those parameters would be.

15 So, the first point is, no, it is not accepted by the Director that this issue of surplus
16 will necessarily arise. How it is to be dealt with under the new legislation, and whether that
17 point is going to be recognised, I am not sure, and cannot say. But, in terms of the position
18 prior to this new legislation, it is quite wrong to say that surpluses will inevitably arise.

19 So far as the situation of surpluses arising goes, the point remains, sir, as you have
20 described it, that there is no evidence that these will lead to net benefits to Thames or to other
21 water companies.

22 THE PRESIDENT: In the balancing arrangement that you referred to just a moment ago, and which
23 is a balance between a deficit and a surplus, I was getting the impression from Mr. Thompson
24 that Thames would not be supplying, as it were, the deficit, if there is a deficit from the
25 borehole. Is that right? Or, if there was, they would be charging for it. Yes, they would be
26 charging for it.

27 MR. TURNER: What happens is that they put water into the system. Other water comes out to
28 supply the customer somewhere else – not the same molecules.

29 THE PRESIDENT: Not the same water, no. Quite.

30 MR. TURNER: If, at the end of the balancing period, there is a shortfall below the margin of
31 tolerance – the agreed margin of tolerance – then a charge is made for that.

32 THE PRESIDENT: For example, the borehole ---- a pump has broken down, or something so that --

33 --

1 MR. TURNER: If the pump has broken down, then Thames will step in completely under its
2 supplier of last resort obligations. The situation I think we are primarily envisaging is where
3 over the balancing period they simply have not hit the demand of the customer at all. I believe
4 we also need to bear in mind that there can be a carry-over. I think you mentioned a six-
5 monthly reconciliation or something of that kind.

6 THE PRESIDENT: Something of that kind.

7 MR. TURNER: But, basically, what they are saying is that within those arrangements you ought to
8 be able to balance without falling outside the envelope.

9 THE PRESIDENT: Right.

10 MR. TURNER: It is only if there is quite serious under-supply that there is a charge, and surpluses
11 simply should not arise. Where they do arise, there is no evidence that these will cause a net
12 benefit to the water company.

13 THE PRESIDENT: Right. So, Mr. Thompson, what is the answer to that – that in a properly
14 organised world it all depends on what is agreed is the margin of tolerance and what is agreed
15 as the balancing period, and so forth, but if the customer's demand is reasonably predictable
16 and your pump is reasonably efficient, taking one month with another, people should remain
17 within the agreed tolerances?

18 MR. THOMPSON: Yes. That may be true, but our narrow complaint – our overs and unders
19 complaint – is that there is no reason why, if you go outside the envelope below, because the
20 hospital, for some reason, needs a massive amount of water, or our borehole produces slightly
21 less, that we have to pay Thames, whereas if the hospital uses rather less and we produce rather
22 more than the envelope, the water that Thames gets is simply free water to Thames. That is the
23 elementary injustice that we see in a system that is meant to be based on the principle of
24 symmetry.

25 THE PRESIDENT: Thank you.

26 MR. THOMPSON: You will have seen in the correspondence, and also I think it is quoted in Mr.
27 Turner's skeleton argument, that there was some reliance on the gas industry. Just for the
28 Tribunal's record, at Tab 18 of the authorities bundle there is a summary of what the practice
29 in the gas industry is, or was at the relevant time. I do not think we necessarily need to go to it,
30 but it may be that that is something which the Tribunal will wish to bear in mind on this issue
31 because it is clearly something which was very much in my client's minds when we said this
32 was unfair.

33 If I can turn to the issue of price, we say that we are not contesting average accounting
34 costs in principle. Our main point is that neither Mr. Turner, nor Mr. Tupper ---- Mr. Tupper

1 does not seem to have even recognised there was such a point. Mr. Turner conspicuously
2 failed to answer it ---- which was that the 27 pence price was far too high, and the Director
3 himself recognised that fact. That has obviously got nothing to do with whether or not, in
4 principle, average accounting cost methodologies are acceptable, or not. We were simply
5 making common cause with the Director in saying that Thames' position was untenable, and
6 that what that should have been is the subject matter of the decision of 8 March, rather than a
7 very poorly reasoned non-infringement decision. So, that is our basic point.

8 Looking at the more specific points, we say that the *Corbeau* case on which Mr.
9 Turner relied is of absolutely no assistance to the Tribunal. Indeed, we found it rather an
10 alarming comparison in that it appeared that the regulator sought to draw some comfort from a
11 case concerning the total exclusion of competition – and, indeed, the flavour of some of Mr.
12 Turner's submissions before lunch were rather consistent with that approach. That obviously
13 gives no comfort to my clients at all as to the approach that the Director is taking.

14 If we move on to the question of ECPR, which loomed its head, our concern in
15 relation to ECPR – at least as applied by this regulator – is that unless ECPR is tightly
16 controlled by reference to the Competition Act, it is wide open to abuse in relation to the issue
17 of margin squeeze in that it is a methodology that takes no account whatsoever of the margin
18 needed for reasonably efficient entrants, but merely looks at the savings accruing to
19 incumbents. Both Shotton and this case illustrate that at least in practice the figures that ECPR
20 appears to generate are conspicuous examples of margin squeeze. So, it seems to us that unless
21 the regulator is robust in relation to his Competition Act duties, ECPR is a potentially
22 disastrous model for access pricing. That is our basic point.

23 Our second point on it is by reference to s.66(e) of the 2003 Act, insofar as that is said
24 to be some form of statutory endorsement of ECPR. I have made submissions about it, but Mr.
25 Turner referred the Tribunal to a guidance document ---- or, a consultation document issued in
26 July 2002, and he referred in particular to paras. 187 and 188. Just as, in my submission, the
27 materials that the Director relied on in Shotton to supports its case in relation to the 2003 Act
28 conspicuously failed to do so, so it appears to me that this document perhaps even more
29 spectacularly fails to do so. If you look at paras. 187 and 188, the first sentence of the
30 document says, "Access and wholesale water charges should reflect the costs of provision of
31 the services provided by the undertaker to the licensee". It does not say anything about a retail
32 minus approach. Likewise, 188 says, "In addition to the normal operating costs of providing
33 common carriage and wholesale supplies to licensees ----" and then gives examples of costs, it
34 then gives further examples of other specific costs which arise in relation to providing access.

1 So, in my submission, this consultation document is entirely consistent with the submissions
2 that I made in Shotton in relation to the true construction of the legislation, and I continue to
3 rely on those submissions in this case.

4 Turning to the points made by Mr. Tupper, I think he said under questioning from
5 Professor Pickering that Albion was, in principle, prepared I think from an early stage to offer
6 a discount to large users. In that respect I would refer the Tribunal to correspondence which is
7 not consistent with that.

8 THE PRESIDENT: It does not matter which bundle you take us to, Mr. Thompson.

9 MR. THOMPSON: I find it easier in Bundle 2. Tab 5, p.23. It is under 1.2 – Large User Discount.

10 In the last sentence, “Thames have set a single charge irrespective of the distance travelled and
11 the customers served, and no further discount is applicable”. So, that was the position on the
12 basis of which Albion complained. The fact that some nine months later, after the regulator had
13 been investigating the matter, Thames made an inadequate offer, as Mr. Turner sought to
14 indicate in assistance to Mr. Tupper, in my submission is absolutely no answer to the case we
15 make in relation to excessive pricing and margin squeeze.

16 The next point Mr. Tupper made was, in my submission, quite an amazing one. It
17 was that if indicative prices are potentially abusive, then I think he said ‘dominant companies
18 will shut up shop’. He appeared to think that not providing any price would be a satisfactory
19 response to any Competition Act complaint. I have to say that had Thames persisted in its
20 position as adopted between May and October 2000, through for another fifteen months, in my
21 submission it would not have been in a stronger position to resist a finding of abuse than it is in
22 this case. Any suggestion to the contrary, in my submission, should be dismissed as ridiculous.

23 The next point that was made was that our case amounted to an obligation to
24 purchase. That is not the position. The question is whether or not some credit should be given
25 for input into a resource deficit area. We have already made our submissions about that.

26 The next point was the desalination plant. Our understanding is that that is a very
27 expensive plant to run, and the reason why it is so expensive is because it is effectively sieving
28 sewage hanging in salt, and that it is apparently easier to remove sewage from salt water than
29 to remove the salt. So, it is a particularly expensive and perhaps rather unattractive form of
30 production of drinking water, but it is not surprising that it adds to the costs of Thames. So,
31 that is a point that we rely on in saying, “Why was it that Thames and the Director, rather than
32 doing that, were not more sympathetic to my client’s rather more traditional form of obtaining
33 drinking water?”

1 Just by way of final submissions, there are one or two points I would like to pick up
2 from yesterday where I think one or two points were raised by Mr. Turner and by the Tribunal.
3 The first one was, “Was Thames aware of the position of Albion as a potential substantial scale
4 entrant into the market?” Indeed, the document that Mr. Turner took you to is perhaps the
5 clearest one – namely, the guarded report which you will find at Tab 5 of Bundle 2, at p.49
6 You will see that this was a document – if you turn over the page – which was actually
7 prepared by Thames Water itself. Mr. Turner took you to the relevant paragraphs where the
8 references are to the substantial holdings, or substantial resources, identified by the
9 Metropolitan Water Company. He did not say – but I imagine it is common ground – that the
10 Metropolitan Water Company was, of course, a subsidiary of Enviro-Logic. One finds that, for
11 example, in the little diagram that appears at para. 15 of the Amended Notice of Appeal. The
12 Metropolitan Water Company was a trading name for the development of water resources in
13 Thames Water’s appointed area. So, Thames was obviously well aware of what the Enviro-
14 Logic group, as it were, were up to. You may remember that the Metropolitan Water
15 Company was the name appearing on the Albion Yard door, even to this day.

16 The next point was whether or not this case represented a test case. Mr. Turner
17 sought to argue that it did not. We would not accept that. Standing back from it, this was the
18 first ever decision that the Director accepted that he had made under the 1998 Act, and just for
19 the Tribunal’s record, as it were, the initial characterisation of the complaint and its character
20 can be seen ---- Perhaps I can just give the references? It is Tab 6 of Bundle 2 again, at pages
21 42 and 54. It may be worth just turning up p.42. You will see it is headed ‘Formal Complaint
22 Against Thames Relating To Access Charges for Common Carriage’. It is put in quite general
23 terms, and the second page, on p.43, identifies a whole series of general points that are
24 suggested as relevant as background to this case. It was, in fact, the Director who insisted on
25 taking the cases, as it were, piecemeal. One finds that, for example, at pages 6 and 7 at Tab 4
26 of the same bundle – in particular, the second paragraph of the letter dated 29 August, 2001,
27 p.7. “Please note, we will refer to this complaint as the complaint against Thames Water
28 relating to access for common carriage to differentiate it from your other complaints against
29 Thames”. So, in my submission, it was clear that this was the test case, as it were, in relation
30 to boreholes, and it was treated in that way.

31 There is in fact another letter which was referred to in our skeleton argument, dated
32 19 October, 2001 which sets out the general character of Albion’s concerns. I am not sure
33 whether that got to the Tribunal, but if I could hand up ----- (Handed) You will see it is a

1 letter to Mr. Fletcher about a meeting on 18 October. In particular, it is the second page – the
2 paragraph starting, “We spoke ----“ It says,

3 “We spoke about our ambitions to develop London’s rising ground water and about
4 the environmental, social and security benefits that our approach will bring. We
5 further discussed the three issues that OFWAT could address as a means of
6 facilitating the benefits of competition : (1) While it is essential to stop the use of
7 submission-LRMC special agreements by Thames Water which are clearly intended
8 to prevent this form of competition; (2) We are quite content to accept the Thames
9 Water approach to access code prices as long as the component costs and
10 denominators are verifiable; and (3) a submission-LRMC allowance for new resource
11 development expresses a discount to the access charge would help address Thames
12 Water’s current supply deficiency efficiently and avoid the anti-competitive subsidies
13 inherent in any cost ... mechanism exceeded these costs”.

14 Then there is reference to the borehole issue in general terms, but in specific reference to
15 Albion and Bathhouse.

16 In my submission, it is quite clear in context that this was a test case and, indeed, I
17 showed the Tribunal yesterday a letter where the Director set out his policy in relation to test
18 cases.

19 There are a number of other points, but I can see the time, and I think I can merely
20 conclude by saying that Albion remains of the view that this is a case which does indeed raise
21 important points of competition policy. The policy documents that Mr. Turner took you to this
22 morning are all very well in their terms, but they do require the regulator to apply a certain
23 amount of rigour, given the exceptionally strong position that the incumbents find themselves
24 in in this industry. Our basic submission is that he has failed to do it in this case, in a slightly
25 different form, but in a similar style to the Shotton case. We therefore appeal to this Tribunal to
26 remedy the situation, and therefore to generate some genuine market competition in this
27 industry as the regulators have achieved in other equivalent industries over the past five years.

28 Unless I can help any further, or anyone else wants me to say anything else, those are
29 our submissions.

30 THE PRESIDENT: We would like to thank everybody very much indeed for the very helpful
31 submissions that we have received. We shall reserve judgment. Thank you.

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