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

Case No 1046/2/4/04

Victoria House,  
Bloomsbury Place,  
London WC1A 2EB

10<sup>th</sup> May, 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**

Appellant

supported by

**AQUAVITAE (UK) LIMITED**

Interveners

and

**DIRECTOR GENERAL OF THE OFFICE OF WATER SERVICES**

Respondent

supported by

**DWR CYMRU CYFYNGEDIG**

and

**UNITED UTILITIES WATER PLC**

Interveners

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**HEARING: DAY TWO**

## **APPEARANCES**

Mr. Rhodri Thompson QC and Mr John O’Flaherty appeared on behalf of the Appellants.

Mr. Michael O’Reilly (instructed by Messrs. McKinnells) appeared on behalf of Aquavita.

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

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

Mr. Fergus Randolph appeared on behalf of the Intervener United Utilities.

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1 THE PRESIDENT: Mr. Anderson, can I just check one housekeeping matter yesterday?  
2 MR. ANDERSON: Yes.  
3 THE PRESIDENT: We gave a Judgment on Aquavitae's application and I think we were technically  
4 in camera when we gave the Judgment. Our normal practice would be to treat that as a  
5 Judgment given in open court unless there is something confidential in it, and I do not think  
6 there is anything confidential in it. So unless there are particular objections from the parties  
7 lodged by the end of today we propose at the moment to treat that as a Judgment given in open  
8 court and put it on the website in the normal way.  
9 MR. ANDERSON: I am sure we have no objection to that but we will double check your precise  
10 words.  
11 THE PRESIDENT: Just before you start, could I just signal that we have it, as it were, in our heads a  
12 mental picture of the plan of the Ashgrove System, which you probably remember from the  
13 site visit which was I think referred to at p.11 of the Notice of Appeal and we are conscious of  
14 the fact that, as far as we are aware, in very broad terms, the existing arrangements suggest that  
15 the water is sold by United Utilities to Welsh Water for about 3p at the beginning of the  
16 system and it comes out at the other end where at the moment, under the existing  
17 arrangements, it is transferred to Albion at about 26p. It is that sort of gap between those two  
18 figures that is one central feature of this particular case that we need to try to understand as  
19 much as we can.  
20 MR. ANDERSON: It is the Ashgrove System?  
21 THE PRESIDENT: Yes, and the price, how one accounts for that price difference.  
22 MR. ANDERSON: We have totalled it so far in relation to the second customer, and referred to  
23 them only as the neighbouring customer.  
24 THE PRESIDENT: Yes.  
25 MR. ANDERSON: It may be that that is clinging on to a confidential piece of information ----  
26 THE PRESIDENT: Well it is difficult to imagine that there could be any other customer, given the  
27 geographical layout of the system, so you will probably have to ----  
28 MR. ANDERSON: Yes, of course. Another central aspect to the case is the importance of regional  
29 average costs rather than looking at the specific costs of the Ashgrove System which we would  
30 submit would be an inappropriate approach and was not the approach adopted in this case.  
31 THE PRESIDENT: Yes.  
32 MR. ANDERSON: I am, rather unconventionally, going to use my skeleton argument as the basis  
33 for my submissions. I call it a "skeleton argument", it is really ----  
34 THE PRESIDENT: People are supposed to use their skeleton arguments, they hardly ever do.

1 MR. ANDERSON: Well, it is true it is more of a sort of fully clothed body, but I think there is still  
2 scope for putting some accessories on it.

3 THE PRESIDENT: Yes.

4 MR. ANDERSON: But it will save your notebooks if I use that as the basis for what I say to you  
5 today. The first section of my skeleton deals with the function of this Appeal and the role of  
6 the Tribunal, and I can take this very briefly. The principal point that I wanted to make was  
7 that, of course, your role in this Appeal is not to act, as it were, as if you were an independent  
8 arbitrator whose task is to set an access price between two parties who cannot agree one. The  
9 function of the Tribunal in this case is to take a view on whether the Director erred in his  
10 Decision. The reason that I make that point is because of the now up to six alternative  
11 calculations that have been advanced by Albion as alternative bases for calculating the access  
12 price which they say should have been applied in this case. The reality is that the Director  
13 looked at the methodology that Welsh had employed in calculating the access price that they  
14 did – a seven step process. The Director came to the view that there had been some  
15 mis-allocation in relation to treatment costs. He then looked at the matter from the point of  
16 view of an ECPR/costs principle, which we will come on to later, and took the view in the  
17 round that there had not been excessive pricing in breach of the Chapter II Prohibition. In  
18 other words, applying the standard of proof that he properly should have applied, namely, was  
19 he persuaded on the basis of balance of probabilities and strong and compelling evidence, that  
20 there had been an abuse of a dominant position, he took the view that there had not been.

21 At a number of points in my learned friend, Mr. Thompson's submissions yesterday  
22 he suggested that the Director had concluded that there was excessive charging – over charging  
23 – arising out of the finding of a mis-allocation of some of the treatment costs. That is the 30  
24 per cent. down to the 15.2 per cent. that you were taken through, and I just want to put paid to  
25 that suggestion at the outset. What is at issue in the complaint and in the Appeal is the access  
26 price that was quoted, not the Second Bulk Supply Agreement. I will be coming back to this  
27 later, but it is important to place down as a mark now that the finding of that mis-allocation  
28 does not lead to the conclusion that there is overcharging on the basis of the Second Bulk  
29 Supply Agreement, and that is important.

30 THE PRESIDENT: Because?

31 MR. ANDERSON: Well, in short because the Second Bulk Supply Agreement is calculated in a  
32 different way to the access price and as one will see, if one looks at, for example, paras.305  
33 and 306 of the Decision the Second Bulk Supply Agreement, although not formally determined  
34 because the Director was not called upon to make a determination was assessed in comparison

1 with a number of other factors including other bulk supply agreements and a new tariff, all of  
2 which were around 26p and therefore the Second Bulk Supply Agreement of 26p is the  
3 appropriate amount. What has in fact happened is, effectively, that the extent to which there  
4 has been a mis-allocation on treatment is made up by what has turned out to be an increase in  
5 resource costs and of course resource costs are not relevant to an access price. So the overall  
6 Second Bulk Supply Agreement, which includes resources, remains appropriately at about 26p,  
7 the price of the Second Bulk Supply Agreement. So, for example, if Albion were to fall out of  
8 the picture and Welsh were to be supplying Shotton direct, the price at which Welsh would be  
9 supplying Shotton is the large user non-potable tariff, which is a price that has been approved  
10 of 26p. That is why it is quite wrong to suggest that because there was a finding of mis-  
11 allocation in the first access price, and there of course there is now a second access price.  
12 Because there had been that finding of misallocation in relation to an access price which  
13 Albion has never had to pay, it necessarily follows that there has been what is called  
14 overcharging in the interim, there has not been, and I will be coming back to that in a little  
15 more detail later just to make that point at the outset.

16 THE PRESIDENT: Just coming back to your first proposition about what the role and function of  
17 the Tribunal is, presumably you would strongly submit that we should not attempt to decide  
18 what the access price would be on the hypothetical assumption, contrary to your submissions,  
19 that we found anything wrong with the existing Decision, but, by the same token, presumably  
20 you would not necessarily challenge our actual jurisdiction to do so if we had sufficient  
21 material upon which to form a view.

22 MR. ANDERSON: I cannot, Sir, because your powers under the Act entitle you to make any  
23 decision that the Director could have made, and so I do not formally challenge the jurisdiction.  
24 I do of course submit that were you to find that the Director's Decision was in some respects  
25 wrong, either a misappraisal, an error of law or whatever, you do not have the material to make  
26 any determination other than the determination that the Director made, not least because of  
27 course we are on the eve of a new regime coming into effect from which one will find the  
28 answer. That is under the new Act.

29 THE PRESIDENT: Yes.

30 MR. ANDERSON: So, in a sense and one of the points we made quite early on in our Defence was  
31 that this is a slightly unusual case coming, as it does, just before a new regime which sets out  
32 how to approach the question of access pricing is about to come into effect.

33 THE PRESIDENT: That will no doubt take us on to something that you may be coming to come to,  
34 which is going to be the relationship between the 1998 Act and the new regime.

1 MR. ANDERSON: I was going to deal with it very briefly. The simple point is this; we are not  
2 suggesting, as was suggested yesterday, that the 1998 Act no longer has any application. What  
3 we do say is that, by virtue of the requirement in s.66(d) to price or fix access prices with  
4 regard to or under what is called the “costs principle”, any undertaker in the position of Welsh  
5 is compelled to use that costs principle and therefore the mere using of the costs principle  
6 cannot amount to an abuse because it is a legal requirement.

7 THE PRESIDENT: Yes.

8 MR. ANDERSON: We say that of course is not removing the role of the 1998 Act, it is merely that,  
9 on that particular issue, that is to say, what methodology should be used under the new regime,  
10 Parliament has dictated what that methodology shall be and therefore the adoption of that  
11 methodology cannot in itself give rise an abuse. That is all I was proposing to say in relation to  
12 the relationship between the two Acts. That is our position on that.

13 THE PRESIDENT: Yes, thank you.

14 MR. ANDERSON: The remainder of my introductory section refers essentially to the role of the  
15 Tribunal and the claim or case, and I have set that out in para.5 109 and 110. I accept that was  
16 a disclosure decision to which I refer, but the point is that in para.109 in the Tribunal’s  
17 Decision the Tribunal referred to the fact:

18 “... we made the point that the primary purpose of this case is to identify whether the  
19 OFT has made any material error of law, whether it has carried out a proper  
20 investigation, whether its reasons are adequate and whether there are material errors  
21 in its appreciation ...”

22 And then, over the page:

23 “The Tribunal has borne this in mind when considering the issue of recovery ... it  
24 should not, at least ordinarily be necessary to go in great depth into the underlying  
25 documents in order to establish whether the decision under appeal is soundly based.  
26 This is not an occasion for Claymore to seek to rework all of the workings that the  
27 OFT made on the basis of the raw material supplied to it.”

28 And that, we would suggest, is what Albion has attempted to do by placing all these alternative  
29 methodologies before this Tribunal.

30 Then on p.6 of my skeleton, to just reiterate that point in relation to better care, the  
31 primary task – and it is really the bit underlined:

32 “... the primary task of the Tribunal will usually be to decide whether, on the material  
33 put before him by the complainant, the Director was correct in arriving at the  
34 conclusion that he did.”

1           One of the points of course made by my learned friend in the Reply was that we, the  
2 Director, were confusing two different burdens of proof; the burden on the appellant to  
3 establish an error on the part of the Director, and the burden is on the appellant to establish that  
4 error, and, secondly, the burden of proof that the Director faced in reaching a view as to  
5 whether or not there had been an infringement. That is the burden of proof of course that has  
6 been discussed and debated and pronounced upon by yourself in a number of cases; that is the  
7 beyond reasonable doubt. But given that we are talking about what would be a serious  
8 consequence for an adverse finding, strong and compelling evidence, the benefit of any doubt  
9 to be given not to Albion but to Welsh before a finding of infringement could be made, and the  
10 Director's view was, on the basis of the material before him and having looked at it and gone  
11 through all the steps that you see in the Decision, he took the view that a case of excessive  
12 pricing had not been made out. The question is, was he right to have taken that view?

13 THE PRESIDENT: I think in *JJB Sports* we said that the phrase "strong and compelling evidence"  
14 should not be interpreted in a way that put the standard of proof too high, and one should not  
15 forget that in the end it is the civil standard though the evidence must of course be convincing.

16 MR. ANDERSON: I accept that it is a civil standard, it is not the criminal standard, and I am not  
17 suggesting it is anything other, but you will see from the Decision that the Director did not  
18 purport to apply anything other than the civil standard, so there is, I hope, no dispute that the  
19 Director applied the correct standard, and that is why we say it is not right to say we have got  
20 the standards confused. We are though in a different position now, which is that there is a  
21 burden on Albion to establish that the Director somehow got it wrong. That is not the same as  
22 coming along to this court as if it were a court of complete first instance, to say, "A complete  
23 blank piece of paper, and now look at what the right access price should be", and that, we  
24 would suggest, is what Albion is attempting to do with its alternative methodologies.

25           The next section is the "Nature of Albion's business", and this of course caused ----

26 THE PRESIDENT: Yes, this is the postman and all the rest of it.

27 MR. ANDERSON: This is Postman Pat, yes. I do not want to spend a great deal of time developing  
28 that analogy. The only point of it was to illustrate that the Director was not satisfied that in this  
29 case Albion, to use your words from yesterday, Sir, have got any added value to the party.  
30 That is the only purpose. Indeed in some respects the analogy was too fair to Albion because  
31 they do not actually take the letter from the postman and put it through the post box; Welsh  
32 does that. They just really stand there and reprint the invoices with their own name on it.  
33 I will be coming to that in more detail.

34           But it is not the case, as was being suggested, that we regard Albion's business as bogus or

1 illegitimate. Those were the phrases that Mr. Thompson used yesterday. It is not a question of  
2 being bogus or illegitimate, it is simply a question that, as a business model, it does not  
3 generate any relevant margin. It is what we call a pure brokerage inset, and by “brokerage”,  
4 and this is a point we have made on a number of occasions, they are in fact in this case doing  
5 nothing other than interposing themselves between Welsh and Shotton and are not changing in  
6 any relevant way the activities Welsh were previously undertaking in relation to Shotton.  
7 Again I will come back to, for example, what is set out in the witness statement of Mr. Jeffrey  
8 as to why that does not take one any further. It may well be that once the water has passed the  
9 gateway into Shotton’s premises Albion is providing a valuable service to Shotton in terms of  
10 advising it how to use its water more efficiently. That may be so. We would regard those as  
11 separate consultancy services that are not material to and, so far as we know, were not supplied  
12 by Welsh previously. Those separate consultancy services may give rise to savings on the part  
13 of Shotton, not savings in the sense of a reduction in the price from Welsh but savings, for  
14 example, in the amount of water consumed by Shotton. If such savings are created, we know  
15 from the supply agreement you were taken to yesterday (para.7.4) that there is a mechanism in  
16 the agreement to share those savings in the proportion of 70:30. That, if you like, is what  
17 Albion’s margin is in this case. That is where it can make some money, but that is distinct from  
18 any margin arising out of any of its activities as a water undertaker arising out of the inset  
19 appointment. It is distinct and it is not relevant, we would submit, to the margin squeeze  
20 argument.

21 THE PRESIDENT: Are you at some point able to help us on what you might say was the essential  
22 difference between the sort of brokerage function that Albion purports to undertake and the  
23 brokerage functions that are now common in other network industries like gas, electricity and  
24 telecoms?

25 MR. ANDERSON: Well one can see an obvious difference between, for example, electricity and  
26 this kind of case.

27 THE PRESIDENT: Is it the fixed physical structure of the network that is the key difference or what  
28 is it?

29 MR. ANDERSON: It is partly that. If one takes, for example, electricity the reason why you can get  
30 the equivalent of inset appointees in electricity is that they can acquire their electricity from a  
31 cheaper source than the incumbent. Now, that is where the so-called “inset appointment retail  
32 competition” is most likely to arise in this industry. If one can obtain an alternative source of  
33 water more cheaply then you may benefit from an inset appointment and displace the  
34 incumbent. Indeed, that is what we understood when we made the inset appointment, that is

1 what we understood Albion's intention was to develop an alternative source from the tunnel.  
2 We have made that clear, that that fact was the basis upon which we granted the inset  
3 appointment. We had some reservations as to whether that was going to be viable and, as  
4 result we granted an inset appointment for a shorter period than would normally be the case,  
5 half the length, and with a much shorter notice period also – the same notice period but one can  
6 give it sooner in the duration of the arrangement.

7 THE PRESIDENT: So if, and it may be hard to imagine because physically we do not have this  
8 situation, but if physically speaking the situation was somewhat different and Albion was able  
9 to go to another water undertaker and say "Can you let me have some water for X price?" and  
10 then go to Shotton and say "I can get water for you from another undertaker for ..." whatever it  
11 is, and there was, by imagination, a pipeline that enabled the water to be supplied to Shotton, if  
12 we imagine that is the case, or perhaps a pipeline could be constructed, that that would be a  
13 perfectly legitimate function.

14 MR. ANDERSON: Of course, yes. There one is bringing, if you like, added value in the sense of an  
15 alternative cheaper source, and my understanding is that that is the kind of situation where a  
16 so-called electricity or gas broker would fit into the picture. They can acquire effectively  
17 electricity more cheaply elsewhere and bring it through the distribution system of the  
18 incumbent.

19 THE PRESIDENT: But that kind of activity, and I just do not know, we do not have perhaps enough  
20 of the big picture, that kind of activity is a bit more limited in water presumably because of the  
21 physical problem of piping the water.

22 MR. ANDERSON: It is more limited and there is no escaping the fact that there is more limited  
23 scope for retail competition in water than in some other industries, but that is just a fact of life.  
24 But to suggest, as Mr. Thompson was suggesting yesterday, that somehow the Director has dug  
25 his heels in and he is against opening up the market to any competition is, we would say,  
26 unfounded. There are some examples – not many – and we have cited them at various points  
27 in our papers, of competition. We have issued access code guidelines, we have consulted  
28 widely, we have done all that we can to discharge our current statutory obligations to facilitate  
29 competition and we are consulting widely and going through the case studies and the exercises  
30 for the purposes of the new regime. But the reality is in this particular case we are of the view  
31 that Albion, on the facts of this case, are not in a similar kind of situation. Another example  
32 would be developing boreholes, although I know very little about the Bath House case so I do  
33 not want to say anything, but that seems to me to be a case where the kind of debate that might  
34 give rise to retail competition is developing an alternative source of that kind, if it were

1 feasible. I just do not know because I do not know the facts of the Bath House case, but there  
2 are examples.

3 THE PRESIDENT: So the Director's position is where feasible it is desirable to encourage this kind  
4 of brokerage activity?

5 MR. ANDERSON: Yes, just that in this case this is not one of them.

6 THE PRESIDENT: Yes.

7 MR. ANDERSON: If the Tribunal has yesterday's transcript to hand we can just look a little at how  
8 my learned friend described the business model. It starts at p.48, towards the bottom of the  
9 page, Mr. Thompson describes the business model as a "retail function", a "water consultancy  
10 function" and a "brokerage function, all of which we submit are legitimate".

11 Taking first the retail function. He accepts that it is a very simple retail model,  
12 perhaps the most simple because there is only one client, one pipe and one source. Then he  
13 refers to the agreement which sets out effectively the two points, one, that Albion has assumed  
14 some statutory obligations as a result of its appointment; and secondly, costs sharing or the  
15 sharing of any costs savings that are generated. (Para.7.4)

16 Towards the end of p.49:

17 "Then there is a list of additional services. So it is certainly true that there is a  
18 contractual arrangement whereby Shotton and Albion share in savings in a ratio of  
19 70:30."

20 We would say that is essentially the consultancy aspect of the arrangement.

21 "But in addition to that there is clearly a retail risk for Albion that Shotton will not  
22 pay for the water..."

23 So what the retail activity identified as the first part of Albion's business model. What it really  
24 boils down to is the assumption of some risk that Shotton will not pay. One could ask  
25 rhetorically what has that saved Welsh? Welsh have had the risk of Shotton not paying or not  
26 being able to pay with Albion not paying or not being able to pay, and if anything that is an  
27 assumption of a greater risk I would suggest on the part of Welsh than the converse. But the  
28 assumption of risk, we would submit, cannot realistically be regarded as a retail activity  
29 deserving of earning any real margin.

30 THE PRESIDENT: How does the Director see the point of view of Shotton in this? Shotton is the  
31 consumer, Shotton is the customer. Shotton is paying Albion for something, what is it that  
32 they are paying for?

33 MR. ANDERSON: Well they are not paying Albion for anything other than they were previously  
34 paying Welsh, that is why they are paying Albion.

1 THE PRESIDENT: Well why are they doing it, because they are paying a bit more?

2 MR. ANDERSON: I cannot answer that, Sir. All I can say is that Shotton are paying Albion what  
3 they were previously paying Welsh, effectively, and are paying what they would be paying  
4 Welsh if Albion were not there. There may be in terms of the consultancy side some costs  
5 savings to Shotton on water efficiency i.e. things that happen after the water has entered  
6 Shotton's premises which Shotton sees some value in. But it is difficult for me to answer how  
7 Albion have persuaded Shotton – I mean it is not costing Shotton anything in terms of the  
8 underlying basic price that Shotton would otherwise have been paying. Albion are charging  
9 Shotton the same price that Shotton were previously paying Welsh, so it has not cost Shotton  
10 anything in terms of the basic water resource, treatment and distribution based price. As I say,  
11 if Albion were not in the picture, Shotton would be paying the large user tariff which is broadly  
12 the same amount as the Second Bulk Supply Agreement. If you would give me just a moment,  
13 and I will see if there is any point on this. (After a pause) No. It may not be a wholly adequate  
14 answer, but that is the only answer that we can give.

15 THE PRESIDENT: Just jogging back a moment, Mr. Anderson, to the question of the finding of the  
16 alternative source of supply, the desirability of brokerage activities, and all that sort of thing, in  
17 this particular case would it make a difference to the analysis if Albion was able to do some  
18 favourable deal with United Utilities, to buy the water from them instead of buying it from  
19 Welsh.

20 MR. ANDERSON: If they were able to secure the cheaper price from United Utilities than United  
21 Utilities were prepared to charge Welsh, although it is difficult to see why that would ever be  
22 the case, then, yes, one could see that there was on paper there a saving. It would be a cheaper  
23 source. But it would in itself raise its own questions as to why United Utilities would be  
24 charging Albion a lower price for the same water than they were prepared to charge Welsh.

25 THE PRESIDENT: But the argument seems to go round slightly in circles because one could  
26 imagine at a different common carriage price even a higher price charged by United Utilities to  
27 Albion for the water might give a more favourable package at the end of the day to Shotton,  
28 assuming Albion also took a margin, than the present bulk user tariff offered by Welsh Water.  
29 It all depends on how you set the access price, does it not?

30 MR. ANDERSON: It all depends on how you set the access price in a sense, but your hypothesis  
31 simply assumes that somehow Welsh is charging too much actually in relation to its large user  
32 tariff. That is the driver of what Shotton would otherwise be paying. If we are right that  
33 Albion is not in fact doing anything and it is nonetheless to be entitled to a margin, that margin  
34 must come out of the price that Welsh is charging. If we are right that Welsh is in fact doing

1 precisely what it was previously doing, all that then means is Welsh should reduce its price. If  
2 Welsh is required to reduce its price in this context the only basis upon which it could be  
3 required to do so would be because its general prices to large non-potable users is too high, but  
4 we know that it is not because it is the large user tariff which has been approved by the Director  
5 pursuant to his statutory duties, as indeed has the second bulk supply price been not determined  
6 but an indication given as to what the Director would determine it at by comparison with the  
7 six selected comparators, the Hyder International Contract, and the long-run marginal cost  
8 normally applied in the context of bulk supply agreements.

9 THE PRESIDENT: But we do know although the bulk supply tariff for large users has followed all  
10 the statutory mechanisms and has fulfilled all the regulatory requirements and so forth, that  
11 price is nonetheless a price that is not arrived at in competitive conditions. It is a monopoly  
12 price, and one of the questions is how far one can say, "Okay, it's all right because it's fulfilled  
13 all the regulatory requirements", when what is being suggested is that you might want to  
14 introduce a bit of competition by obtaining water from an alternative source but you cannot  
15 actually do that unless you arrive at a common carriage price that gives the broker some margin  
16 in order to offer it.

17 MR. ANDERSON: But not margin out of that part of the common carriage price which is the same  
18 for everybody. If there is to be a margin that enables the new entrant to undercut it is a margin  
19 that must be attributable to some saving or efficiency or added value brought into the system;  
20 that is to say, if he can find a cheaper alternative source that will be the source of his margin.

21 THE PRESIDENT: Do you want to ask a question?

22 PROFESSOR PICKERING: Mr. Anderson, you I believe have indicated that, so far as the Director  
23 is concerned, there is not one precise price that would be the right price, but that the Director in  
24 assessing the reasonableness of the prices charged has taken a view that, in the round, this is in  
25 about the right sort of ball park figure.

26 MR. ANDERSON: Yes.

27 PROFESSOR PICKERING: So there could be a range of prices, and the Director might equally  
28 have said, "There is no abuse, this is all right"?

29 MR. ANDERSON: Yes.

30 PROFESSOR PICKERING: In most market situations one finds a retail price, or indeed any other  
31 price in a distribution chain, being determined in part by negotiation between a willing buyer  
32 and a willing seller.

33 MR. ANDERSON: Yes.

34 PROFESSOR PICKERING: In this case you seem to be inviting us to accept the argument that the

1 price is determined solely on the basis of costs and that one builds up a price from the  
2 components of cost, treatment, distribution and so on, and that there is no scope then for  
3 negotiation about the final price. Is that what you are inviting us to accept, that this is different  
4 not only for the structural reasons but in terms of the way in which the ultimate price is  
5 determined?

6 MR. ANDERSON: That is the reality, I am afraid, of this market, where there are natural  
7 monopolies. It is a very heavily regulated market and the prices are reviewed and need to be  
8 approved. But there are situations, and we have cited some examples, where competition has  
9 been introduced, and the *Northern Foods* example is one, the *Buxted Chicken Farm* is another  
10 example where there will be an element of competition, and of course Parliament, Government  
11 and the Director are doing all they can to introduce competition, bearing in mind the  
12 complications associated with universal service obligations and the need to ensure that the  
13 interests of rural customers and so on and so forth are maintained. So it is not competition for  
14 competition sake, it is competition recognising these special features. But it is true that to a  
15 significant extent the prices charged under the large user tariffs are cost driven, and they are  
16 cost driven on an average accounting basis to meet with Government objectives of ensuring  
17 that the existing subsidies to those who would otherwise be more expensive to supply, and  
18 therefore would pay more, those costs subsidies are not on one ----

19 PROFESSOR PICKERING: Without wishing to play the semantics too far, may I invite you to  
20 consider whether there is a difference between a price that is cost driven and a price that is cost  
21 determined. Is there no scope for a purchaser, for a significant purchaser, to negotiate with the  
22 water supplier?

23 MR. ANDERSON: There have been examples where a water undertaker has struck a deal with a  
24 large user who has a number of sites and offered to that customer if you like what is called a  
25 “one-stop shop”, but in terms of the prices that that undertaker has secured from the incumbent,  
26 those again are based upon the large user tariff, which may in any one instance not give rise to  
27 a margin but overall may well give rise to a margin.

28 PROFESSOR PICKERING: Yes, so there is scope for negotiation?

29 MR. ANDERSON: There is some scope for negotiation, yes, of course.

30 PROFESSOR PICKERING: And would it be possible ----

31 MR. ANDERSON: Certainly in relation to bulk supply agreements there is some scope for  
32 negotiation, and if the negotiations break down then the Director is called upon under s.40 to  
33 make a determination, and indeed that is what could have happened in relation to the Second  
34 Bulk Supply Agreement here, although, to be fair, the Director did indicate what he would be

1 minded to determine if he were actually called upon to determine the Second Bulk Supply  
2 Agreement.

3 PROFESSOR PICKERING: But if we accept ----

4 MR. ANDERSON: But of course bulk supply agreements are between water undertakers. They are  
5 a different animal to large user tariffs or special agreements, which are the prices to customers.

6 PROFESSOR PICKERING: If there is scope for negotiation between a purchaser and the undertaker  
7 then is it not possible that that ultimate purchaser or ultimate user might actually invite  
8 somebody else to act in a brokerage role in seeking to negotiate that price, and is this perhaps –  
9 and I do not know the facts – but is this not perhaps the role that Shotton Paper were envisaging  
10 that Albion would play on their behalf?

11 MR. ANDERSON: That is perfectly possible. I do not know the answer. But you were taken to a  
12 press release of the Director's in which he indicated that the role of individuals such as  
13 Dr. Bryan and his Albion company, may well have the result of water undertakers – I would  
14 not say seeing the writing on the wall, but water undertakings reviewing their pricing and  
15 perhaps, as in the case of Welsh, introducing the large user non-potable tariff rather than the  
16 existing network of special agreements and so on. So it may have some kind of a knock-on  
17 effect in that sense.

18 PROFESSOR PICKERING: Might it not then be the case that here we have a situation that Albion  
19 has been entrusted by Shotton Paper to engage in this negotiation role, has found that Welsh  
20 Water was unwilling to vary the price that it had determined on the basis of a build-up from a  
21 costs basis, and has had that confirmed by the Director which, if so, might actually be felt to be  
22 unfortunate in that it has actually discouraged the setting of perhaps a more interesting price, if  
23 one might use that term, through negotiation, even recognising that the alternative forms of  
24 competition on the supply side, through the introduction of new sources of water, has not  
25 proved possible?

26 MR. ANDERSON: You may well be right that the thought process going through the minds of  
27 Shotton and Albion, and obviously I am not in a position to speak to it, but it may well be that  
28 the thought process going through Shotton and Albion was that if they got together and put  
29 enough pressure either through employing the Competition Act and then bringing an appeal to  
30 this Tribunal they would be able to secure some kind of a lower price rather than develop the  
31 alternative sources, which was the basis of the inset appointment. That might well be so, but  
32 I would submit that that is not a water undertaking retail activity that justifies the generation of  
33 a margin in the price from Welsh to Albion.

34 PROFESSOR PICKERING: But is it not something that in terms of the overall role of the Director

1 there ought to be proper consideration to encouraging negotiation on prices and not simply to  
2 enshrine a price that is built up, although it may be a reasonable price, and I am not prejudging  
3 that, but a price that is built up on the basis of a view about costs.

4 MR. ANDERSON: That is essentially, if I may respectfully suggest, a matter for Parliament which  
5 Parliament has addressed in the new Water Act, s.66, and the costs principle. But the Director  
6 has certainly encouraged, in the sense of developing and publishing his access code guidance,  
7 transparency in this entire process, so that the Director has certainly done what he can given the  
8 industry in which he is the regulator and the sort of problems that are associated with trying to  
9 introduce widespread so-called retail competition. So I would suggest the Director has done all  
10 that he can, and it is not that he is seeking to entrench the existing situation. Regional average  
11 costs are the basis for pricing in this industry, and, in that respect, what Welsh has done in  
12 formulating the access price to Albion cannot, in our submission, be said to have abused a  
13 dominant position. Indeed had it embarked on any other basis than applying regional average  
14 costs, it would find itself in conflict with the guidance which we have set out at length in our  
15 skeleton, which requires it to apply a consistent approach across its pricing, and, given that its  
16 approach to pricing in the large user tariff and bulk supply agreements of this kind are driven  
17 by or determined by average regional costs, to have sought to exercise an entirely different  
18 approach to quoting an access price would have been an inconsistent approach to pricing.

19 PROFESSOR PICKERING: I think the distinction between “driven” and “determined” is the  
20 important one. I am not suggesting, nor is anybody, that regional average cost or whatever is  
21 not the basis on which a sensible price may be determined, nor would one suggest that it is not  
22 appropriate for the Director to have regard to the cost basis on which a price is determined.  
23 But what I wanted to put to you is the notion that presumably the Director would want to  
24 encourage at least then some interaction between supplier undertaker and ultimate user in order  
25 to see whether there was something that could be then the basis of a negotiated price.

26 MR. ANDERSON: Yes, he does, but there are limits to his powers. In the context of a bulk supply  
27 agreement if the parties cannot negotiate then he has the power to determine. His powers to  
28 approve large industrial tariffs, indeed tariffs generally under the Act are set out in the  
29 guidance and the approach he adopts, that is cost based – regional average cost based. So  
30 when it comes to him as a matter of last resort having to determine then he will adopt the same  
31 approach he expects the industry to adopt, namely regional average cost, as being the basis for  
32 setting those prices. That is the basis upon which the new tariff was set. It is the basis upon  
33 which the other bulk supply prices that were compared with this bulk supply price were used,  
34 the second bulk supply price, and the ECPR price. So there is a consistency across the board.

1 In this particular case, of course, one of the problems Albion was facing was, even in the  
2 context of a negotiation, it was not able to identify any distinction between what Welsh would  
3 charge Shotton under its large tariff and what it should charge Albion, because it was not doing  
4 anything different. It was simply replacing one customer with another. That has always been  
5 the problem that Albion faces in the facts of this particular inset appointment.

6 THE PRESIDENT: I think we had better press on now, Mr. Anderson.

7 MR. ANDERSON: Yes. So that takes me through essentially the Albion business model, and if I  
8 can now turn to p.11 – Albion’s essential complaints. The structure of this skeleton argument  
9 reflects the structure of my learned friend, Mr. Thompson’s skeleton argument, and at the  
10 outset of his skeleton argument there were a number of essential points made, and I can go  
11 through these quickly because they were not developed really in oral argument.

12 The first point is, I would submit, a bad point. It takes figures out of the Director  
13 General’s MPV calculations which were part of the exercise of determining the essential  
14 facilities’ argument, namely what would be the costs of replicating this system? The point that  
15 Albion seeks to make identified in para.19 is that if you look at those costs you get to a total of  
16 6p. It therefore follows that an access price in excess of 20p must be excessive. Of course, the  
17 short answer to that is that all those figures look at are the direct operating costs of replicating a  
18 system. It does not include anything in respect of the costs of maintaining that stock, or return  
19 on capital and all the indirect and common costs. Looking at it from the point of view of an  
20 industry average – and this is the point towards the bottom of para. 20 direct operating costs  
21 are typically of the order of 20 per cent. of the overall costs, and if one were therefore to regard  
22 6 per cent. direct operating costs derived from annex 1 to the Decision, 20 per cent. of the  
23 overall cost, that would in fact give a total supply price to Shotton of somewhere closer to 30p.  
24 So that is why we say that is not a good point.

25 The second point was that the infrastructure system serving Shotton is in fact simple  
26 and antiquated. I do not believe Welsh would accept either adjective, but the reality is that that  
27 is a local costs’ point. It is what is called “geographic de-averaging”, and perhaps I could just  
28 explain what we mean by “de-averaging”. De-averaging is where, and this is essentially  
29 Albion’s fourth methodology, they seek to identify out on the basis of a specific geographic  
30 location, namely, the supply from Heron Bridge to Sealand and identify the costs referable to  
31 that. That is not the same thing as recognising in the round, throughout an entire region,  
32 throughout the entire country, that there will be differences between treating water to a potable  
33 standard and treating water to a non-potable standard. That is not de-averaging, that is simply  
34 recognizing across the entire country that there will be different costs associated with those two

1 activities. So the complaint, or the suggestion that the Ashgrove system is simple and  
2 antiquated is, we would submit, a red herring on the question of how to identify the correct  
3 costs for the purposes of setting the price.

4 THE PRESIDENT: Just let me check that I have understood it so that you can put me right. You are  
5 essentially saying that one cannot just look at the cost of this particular system, which we have,  
6 or a lot of us here have now seen, which to a lay eye did not appear to be that complicated or  
7 that modern, one can not just look at that system because the globality of Welsh Water's  
8 customers, or the globality of water customers – put it that way – need all to bear some  
9 proportion of the total cost of supplying water in the region and not just the particular costs of  
10 the particular system that they happen to be closest to.

11 MR. ANDERSON: Yes, so for example, take household customers, the people who live in terraced  
12 houses are not charged a lesser amount than the farmer who lives way out in the valley simply  
13 because he is way out in the valley. That is what average cost based pricing is all about. The  
14 same is true in relation to non-potable treatment works. We, and I believe Welsh, would not  
15 accept that the Ashgrove System is antiquated and simple. One sees from Lynette Cross's  
16 witness statement there has been a great deal of investment in it. It is served by one of these  
17 massive 600 mm pipes through which huge quantities of water travel. However simple we, as  
18 lay people, may regard it, it is a treatment facility at Ashgrove, it is not a reservoir. It is  
19 possibly true that reservoirs, whose primary function is storage, may have some effect on the  
20 quality of the water but that is not why reservoir is there. Ashgrove is there simply to treat, it  
21 serves no other purpose, it is not a storage facility or anything. The reality is that the Ashgrove  
22 System, whatever view you may have taken on your visit, the Ashgrove System is a treatment  
23 system. It is not a reservoir, and therefore the water travelling through the Ashgrove System  
24 cannot be categorised, and is not categorised in Welsh's regulatory accounting guideline  
25 returns, is not categorised as a raw water aqueduct. We have gone on at length in our  
26 pleadings to demonstrate that if you apply the right figures the average raw water aqueducts in  
27 the Welsh system are only about 2 kms, this is 15 kms, indeed 15 kms is as the crow flies, in  
28 terms of the actual length of pipeline it is about 21 kms, because for example the pipe splits in  
29 half to go under the river and so on, so it is about 21 kms of actual pipeline, and that is not  
30 comparable to the typical raw water aqueduct which, as I say, is about 2 ½ kms, about the same  
31 as Heron Bridge to Ashgrove. The essential point is, of course, that none of that matters  
32 because the correct approach is regional average costs.

33 Indeed, as we have said here in the skeleton and elsewhere, although Albion  
34 originally advanced a local costs' argument they abandoned it. We accept regional average.

1 Of course, it has gone up and down. It became “We accept regional average”, it was then “We  
2 accept regional averages provided they are the same as local costs” which is in a sense a bit of  
3 a nonsense, and then back as late as the Reply, accepting regional average prices, and a lot of  
4 their methodologies are attempting to ascertain the correct regional average costs for  
5 non-potable distribution, that is at the heart of some of their methodologies.

6 The next points on inheriting particular infrastructure, we would say that is red  
7 herring. The important point is looking forwards, what investment may be required to replace  
8 it over the future. The return on capital point I will not dwell on. Then there is the internal  
9 inconsistency in step 4, but I just invite the Tribunal to go back and go through step 4 at your  
10 leisure. I am not going to do it now because the bottom line is that the Director saw the  
11 inconsistency, read it through, worked it out and took the view it was not an inconsistency that  
12 led to any need for any material adjustment. It ends up with the difference between 15.8 as  
13 opposed to 16p and on that basis took the view that there was no need to make any adjustment  
14 referable to that inconsistency.

15 The next point that was made, although again not developed yesterday was – and I am  
16 not sure whether this is a point of discrimination or just a point on excessive pricing, but they  
17 have identified the Elan Valley Bulk Supply Agreement and the First Bulk Supply Agreement,  
18 that is to say the agreement between United Utilities and Welsh, and have said that those prices  
19 are so much lower, does that not show that we are being charged an excessive amount? We  
20 say “no”, that is not a sensible comparison. Elan Valley is a completely different animal. It is  
21 a historic agreement, huge quantities, pre-privatisation between two Secretaries of State,  
22 political implications and it is water only, so it does not include any charges for maintenance,  
23 transportation or treatment which do apply in the case of Albion. Similarly, in relation to  
24 United Utilities that First Bulk Supply Price is only for the water, there is no treatment.  
25 Indeed, even in relation to abstraction there is this costs’ sharing arrangement. All right, I may  
26 have described it slightly incorrectly in the skeleton argument and that is why we put in the  
27 erratum letter last Friday which my learned friend tried to make what I think he fairly  
28 described as only a “jury point”, but the reality is that it is a very different animal to either the  
29 First Access Price or the Second Bulk Supply Agreement, therefore no conclusion can be  
30 drawn from the fact that it is a smaller amount. It is for a different service, it is for different  
31 goods. I just dwell on that slightly because it was one of the points that the Tribunal raised in  
32 its Letter of Issues.

33 THE PRESIDENT: Yes.

34 MR. ANDERSON: The next point that I make at para.27 is simply that this access price is not out

1 of line with prices generally within the industry. Within a regulated industry perhaps  
2 comparator pricing of this kind at least assists in trying to get a feel for whether a price is very  
3 out of line or not. What we have said there is if you look across the board large non-potable  
4 pay within the range of 20p – 30p and the access price plus the resource price paid to United  
5 Utilities falls squarely within that range. We also refer to the Hyder International Agreement  
6 which is 28p and the six non-potable large users is a debate which has not really surfaced since  
7 the Defence, but you will recall that there were 10 comparators. There were six which we  
8 regarded as appropriate comparators and those were all consistent with 26p. There were others  
9 which were smaller, what were called the “neglected four”, and we have explained in our  
10 pleadings why we did not use those, and that is because most of those were at a lower level  
11 because they had made very significant capital contributions to the relevant infrastructure and  
12 therefore were charged at a smaller volumetric rate.

13           It is true that there was a capital contribution made in the case of Shotton. It was also  
14 made by the neighbouring company, indeed, I think they also have been contributed to by  
15 Welsh, I am not sure, but it was in total, I think, about 190,000 and I think it was for  
16 connecting the Rotork valve to the remote system at Bretton, but it has not been reflected in  
17 any of the prices charged to either the neighbouring company or Shotton, so it is an irrelevant  
18 point. But in terms of those four that we did not use as comparators, there were very  
19 significant capital contributions that resulted in very different prices, and it could not sensibly  
20 be used as a comparator. But on every relevant comparator that we have used this price is in  
21 line with the access price and, indeed, the Second Bulk Supply Agreement.

22 THE PRESIDENT: Can I just try to clarify in my own mind something that is confusing me a little  
23 bit. The prices that you are quoting here in para.27 are the prices for a water supply, i.e. this is  
24 what the user is paying for his water.

25 MR. ANDERSON: Yes.

26 THE PRESIDENT: Now if in this particular case the water cost had been 15p rather than 3p would  
27 that mean that the Director would still have set an access price 23p, or would it mean that the  
28 access price would, as it were, have come down so that the overall cost to Shotton was not  
29 above these average prices of between 26 and 29 that you refer to here?

30 MR. ANDERSON: It depends, Sir, by what you mean by the water cost. If you mean the water  
31 resource cost, you clearly deduct the water resource cost from any access price, because the  
32 person providing the common carriage is not providing the water. By definition somebody  
33 else’s water is being introduced into the system, so you clearly do not charge a resource cost  
34 for that. You charge the treatment and distribution cost. Now if, on your hypothesis, the water

1 resource cost was 15p then clearly the right access price would not have been 22p. It would  
2 have been effectively 26p less the 15p under the – that would be an ECPR calculation but one  
3 would, by another route, get to much the same result by going through the seven steps that  
4 Welsh went through. You will recall in the seven step approach water resources are also taken  
5 out of the access price. So if the relevant water resource, and again I reiterate we are talking  
6 about average water resource costs, not specific water resource costs, if the average water  
7 resource cost was a higher figure, then of course the access price would be lower. The Second  
8 Bulk Supply price -----

9 THE PRESIDENT: If the water resource cost was higher then access price lower.

10 MR. ANDERSON: Yes.

11 THE PRESIDENT: Well what I am struggling to reconcile in my own mind is how this is supposed  
12 to work, because one might have thought simplistically, and I think from memory this is how it  
13 happens in gas, but I may be completely out of date now, that for the service of carrying the  
14 water, the cost of the pipes, and the treatment and all the rest of it. You can work out on some  
15 cost based principle what that costs to do, and arrive at a charge for common carriage on that  
16 basis. But, in principle, that charge should not vary with the cost of the input, the water that is  
17 actually being carried, which is a different animal.

18 MR. ANDERSON: Yes.

19 THE PRESIDENT: Treat me like a child, Mr. Anderson, and just take me through it again, as to  
20 how this works. I am probably getting hold of the wrong end of the stick, but it seems a bit  
21 squashy, this calculation. It seems to sort of arrive at the number you first – the end result  
22 arrives at the number you first thought of, because where you want to arrive at is a price that is  
23 within the existing range of what people are paying instead of actually rather rigorously taking  
24 the cost of the carriage element and then adding on whatever the water cost is.

25 MR. ANDERSON: In a sense what you say is right. The starting point is to take total costs, the total  
26 costs that are submitted under the regulatory accounting guidelines. One then has to identify  
27 out of those total costs what are the different ingredients, because we are only interested in the  
28 distribution and the treatment costs, and therefore the exercises identify from those total costs  
29 what the three components are, and that is the exercise that Welsh undertook. All I am saying  
30 in answer to you, if the resource costs alters, is I was assuming in your hypothesis that total  
31 costs have not changed. If resource costs went up from 3p. to 15p. then total costs would go  
32 up, but the distribution and the treatment element would not alter. Sir, I may have  
33 misunderstood your hypothesis. I assumed by your hypothesis you were suggesting a much  
34 larger proportion of total costs were attributable to the resource cost than in this case, but if

1 your hypothesis is simply that the resource cost has gone up then the mere fact that the resource  
2 cost has gone up would not alter the access price at all.

3 THE PRESIDENT: So the access price – I am struggling to understand, and it is only a question of  
4 understanding it, whether the access price varies at all depending on what the price of the water  
5 is.

6 MR. ANDERSON: It does not in itself vary at all, no. The calculation, deriving it from total costs,  
7 may result in a different amount if the proportion of total costs referable to resource is higher or  
8 lower, but all that is is a comparison of distribution and treatment costs to total costs. It is not  
9 that the common carriage price, the access price, or the treatment of distribution costs, change,  
10 it is merely that distribution and treatment costs as a percentage of total costs will vary if the  
11 percentage of resource costs to total cost varies. I hope that has answered your query.

12 THE PRESIDENT: I think we may have to come back to it, but let us go on for the moment.

13 MR. ANDERSON: Let me turn now to the Director's case, in a nutshell, on excessive pricing, and  
14 that is at para.17. The test the Director employed was the test set out in *United Brand*, the  
15 threefold test. Did Welsh misallocate costs? Did the access pipes bear no reasonable relation  
16 to the economic value? If yes, was the price in itself unfair? And of course in this case we did  
17 not get to step 3 because under step 2 we concluded that the price did bear a reasonable relation  
18 to the economic value, or rather, it had not been established that the price did not bear a  
19 reasonable relation to the economic value.

20 So in applying the first stage of the test we were satisfied that employing the average  
21 accounting methodology used by Welsh was the correct approach, not only a sound and  
22 reasonable approach, as I say there, but the approach that should have been adopted because  
23 that was the approach it adopted throughout its pricing, and it would have been inappropriate to  
24 adopt a different methodology in the cash of Ashgrove. So, for example, if instead of a system,  
25 to use Albion's description, which was not antiquated and simple but was modern and  
26 sophisticated, to have adopted a local cost approach and arrived at a figure that was higher than  
27 its large user tariff equivalent, on the basis that this particular system is highly sophisticated  
28 and expensive to run and therefore you will charge more, that would have been inconsistent  
29 with Welsh's regional average cost pricing. So there is inevitably, as is bound to be the case  
30 with regional average pricing, swings and roundabouts. Whether this is a case of losing on the  
31 swings we cannot say, we have not done a local costs analysis, and it is inappropriate to do so.  
32 But there may be cases where there are losers and winners as a consequence of regional  
33 average pricing, and the key point is that Welsh adopted the methodology that it adopts  
34 throughout its pricing, which is regional average pricing.

1           We did take the view that there had been some misallocation, and that is the  
2 misallocation arising out of using 30 per cent. rather than the 15.2 per cent. We did not need to  
3 dig any deeper in relation to the 15.2 per cent. because that exercise effectively had been done  
4 in the context of the new tariff. The critical reason for making the adjustment from 30 to 15.2  
5 per cent. was effectively why have you used 15.2 per cent. for your large user tariff and not  
6 here? There was no answer, or no sufficiently persuasive answer for the Director, so he  
7 concluded, “You should apply the same”, and that is therefore the reduction. But that does not  
8 lead to the conclusion that there was necessarily an abusive price quoted. We looked at what  
9 the position would be under ECPR, and here, if I could just pause for a moment and make a  
10 point, which is on the one hand we seem to say this is relevant, on the other hand we say it is  
11 irrelevant. The point is simply this: ECPR/costs principle was used. I would not describe it as  
12 a cross-check, but it was used as one of the approaches the Director adopted in taking his view  
13 as to whether there was excessive pricing. Comparing the price arrived at under that system  
14 and the price arrived at under Welsh’s system as adjusted, we took the view that the access  
15 price quoted was not excessive.

16           Where we say this issue is irrelevant is in this sense: whether or not the Director’s  
17 approach to ECPR that he adopted, namely take the existing retail price and deduct resources,  
18 whether or not that is precisely what s.66E requires you to do is not strictly relevant for this  
19 Tribunal to decide, it is a statutory regime that is not yet in force. That is all I meant by  
20 “irrelevant”. I am perfectly happy to and will be addressing the construction of 66E because  
21 Mr. Thompson yesterday got it wrong, and I will take you through it.

22 THE PRESIDENT: I think it would be helpful to have your submissions on that.

23 MR. ANDERSON: I will take you through it at any moment you wish.

24 THE PRESIDENT: When convenient.

25 MR. ANDERSON: But it was going to be towards the end, but we really ought to press on.

26           So that was the view that the Director then took, applying ECPR.

27           There is some debate as to whether the Second Bulk Supply Agreement was the right  
28 retail price, was it excessive, was it not, and that I have addressed in para.36. The Second  
29 Bulk Supply Agreement was not formally determined, and I do not want to make too much of  
30 the point, that if Albion did not like the Second Bulk Supply Agreement they could have asked  
31 for determination, and if they did not like that determination they should go for Judicial  
32 Review, because the reality is that the material that is before the Tribunal and was before the  
33 Director is sufficient to discharge his suggestion that the Second Bulk Supply Agreement at  
34 26p. is an inappropriate amount, because we looked at it, and after extensive public

1 consultation, and having regard to various access comparators, as I say, and having regard to  
2 the long-run marginal cost, came to the view that 26p. would be about right if we were required  
3 to make a determination. It is also of course consistent with the new tariff, which adopts  
4 regional average cost pricing and comes out at 26p. again, and the reason why – my learned  
5 Junior points out to me that it is true that criticisms of the Second Bulk Supply Agreement  
6 have been made by Albion. They are addressed in detail, one by one, at paras.111 to 120 of the  
7 Defence, and in paras.51 and 52 of the rejoinder. But the essential point is of course that the  
8 reason why there is a difference between the Bulk Supply Agreement being right and a  
9 misallocation that might otherwise have resulted in a reduction in the access price is to do with  
10 subsequent increases in resource costs, because a Bulk Supply Agreement includes the cost of  
11 resources, the access price does not. Paying for the water as well as the treatment and  
12 distribution under the Bulk Supply Agreement, you are not paying for the water, and that is  
13 explained in the Decision.

14           There is then the cross-checks advanced by Albion in this case, and we have set out  
15 on p.20 of my skeleton what our principal criticisms of that general approach are. The first is,  
16 and I do not make a great deal of this, those alternatives were not in fact advanced in the  
17 complaint, at least not in full. There are conceptual flaws in every one of those methodologies.  
18 We set out in our Defence some conceptual flaws to what at that stage were only three  
19 alternative methodologies. The first one sought to create a profit and loss account out of  
20 matching the June returns with the regulatory account guideline returns, and the point we made  
21 in relation to that methodology was you cannot create a profit and loss account from that  
22 because the category you have chosen from the June returns for revenue includes many other  
23 things than are relevant to non-potable supplies, whereas the regulatory account guideline  
24 figures you are using exclude a whole range of relevant costs, common costs, return on capital,  
25 bad debts, all that sort of thing, so you are creating out of two different sources a meaningless  
26 profit and loss account, and therefore all the conclusions that flow from methodology 1 are  
27 misconceived.

28           That is explained in more detail because following voluntary disclosure Albion then  
29 sought to fine tune all those methodologies. Our criticisms of those methodologies are then set  
30 out in more detail in our rejoinder, summarised in the body, gone through line by line in annex  
31 2 to our rejoinder, and annex 2 to our rejoinder remains today unchallenged. Mr. Thompson  
32 yesterday described it as a “cop out”, and I think that he may have been unfair on himself, but  
33 he decided not to take you to those methodologies. They are all fundamentally flawed. They  
34 are irredeemable in terms of conclusions one could draw from them, and we have set out at

1 length in relation to each one of those methodologies why they are flawed. We have done the  
2 same in relation to methodology 4, which is the Ashgrove local costs methodology.

3 I only want to dwell briefly on methodology 3, because methodology 3 is one that is  
4 directed to potable/non-potable distribution costs. The essential error in methodology 3 is to  
5 confuse raw water aqueduct with non-potable mains and, as a result, all the calculations  
6 designed to show a difference between potable and non-potable distribution costs fall away. If  
7 the right figures are used, and this is all set out in annex 2 to the rejoinder, for the relevant  
8 pipeline and the relevant quantities it is clear that the costs of potable and non-potable  
9 distribution systems are broadly equivalent. Now, that was the assumption the Director made  
10 in his Decision. We are criticised for making that assumption in paras.302 ----

11 THE PRESIDENT: It is para.300 I think, around there.

12 MR. ANDERSON: Yes, I am obliged.

13 THE PRESIDENT: And it was said yesterday that we should – we were invited to treat this pipeline  
14 as a raw water aqueduct and it was said, among other things, that it was so classified in some  
15 list of assets.

16 MR. ANDERSON: I will come to that point. Yes, it was classified in that list of assets. That asset  
17 inventory, if you look at line 17, there is nothing in there at all for “other”, so what is included  
18 in the raw aqueduct – I mean, this may or may not have been right of Welsh to classify them  
19 there, possibly not – that category though of raw water includes everything. It includes a whole  
20 range of types of pipe. It is used, if you like, as a sort of left-overs, because what that asset  
21 inventory is seeking to identify is the potable system and therefore everything else has been put  
22 into that category. So it is simply misconceived to use that category and that length of pipe as  
23 the appropriate length of – it includes far more than just the 600 mm pipes.

24 THE PRESIDENT: Yes, I am just jogging back to the rejoinder to see where you had dealt with all  
25 this.

26 MR. ANDERSON: It is annex 2 to the rejoinder. I have dealt with it all at p.64 of the rejoinder.

27 No, that is methodology 2, I am sorry. Methodology 3 begins at p.70, and it went through two  
28 stages. It started by identifying treatment costs. We have used the figure of 3.2. You will  
29 remember that 3.2 is the figure that is down from 7.2 to 3.2 because of the 15 per cent. change.

30 THE PRESIDENT: Yes.

31 MR. ANDERSON: This methodology now uses 1p., which we say is plucked from the air but,  
32 wherever it comes from, what it does not include are all the costs that have been paid, and there  
33 is simply no reason why those should not be included – contributions to common costs,  
34 overheads, capital costs, depreciation, all those aspects. It is wrong to begin with; it is too

1 small a figure. So that is for the treatment side, and we say, on any view, you should be using  
2 3.2 and not the 1. They then make an adjustment to add in a return on capital, but of course  
3 they have added in only a limited return on capital because they are starting from a lower  
4 starting point. They are including less in it. So our conclusion on the treatment side is that,  
5 even in relation to the treatment side, the step 1 figure is too small.

6 We then turn to distribution costs, and what it is intended to show is that the 16p. used  
7 by Welsh is manifestly excessive. Their argument is that using 16p. for both potable and non-  
8 potable Welsh would need to charge itself 52 million for the potable trunk network on the basis  
9 that it is 326,000 ml passing through that system and 79 million for the non-potable. They say  
10 that that is clearly an excessive amount. We say you have used too large a figure for the non-  
11 potable, it is nothing like 495, you have to use 27,000 and that reduces it considerably down to  
12 4.3 million which, on no view, is excessive. It appeared to us that they appeared to accept that  
13 point because at that stage in their re-tuned methodology three they move into an alternative  
14 approach. The alternative approach is to calculate first the cost of the potable network, and  
15 there they use potable mains of 26,000 km of which the trunk mains are 9,500. They contend  
16 that Welsh recovers 5,500 per km of trunk mains, that is calculated on the basis of  
17  $16p \times 326,000$  mls of potable water travelling through the trunks, divided by the 9,400 kms,  
18 which are the trunk mains.

19 We say in answer to that, first, that the 9,400 is factually incorrect, and it appears that  
20 they derive the 9,400 from the 35 per cent. You will recall the 35 per cent. yesterday as being  
21 35 per cent. is the proportion of total distribution costs that should be apportioned to the largest  
22 size of pipe. You will recall that Mr. Thompson was making the point that such a large  
23 proportion of total costs being attributable to such a small part of the network seemed  
24 intrinsically unlikely to him, and the answer simply is, as he described it, that is the heart of the  
25 system. These are the huge pipes through which all water travels at some point. It is the most  
26 valuable part of the network and therefore it is no actual challenge to the 35 per cent. in the  
27 sense of anything that is put to you to doubt it. That is the figure that has been used in relation  
28 to costs. It does not follow from that that 35 per cent. of the total network length is referable to  
29 those large diameter pipes, which is the mistake that they have made in that stage of this  
30 methodology.

31 THE PRESIDENT: It is a bit difficult for Albion to get to the bottom of all this because you have  
32 figures and they have not.

33 MR. ANDERSON: They do have figures because in the documents that are annexed to the Notice of  
34 Appeal and in the voluntary disclosure, those are the figures from which they have made these

1 calculations. We have used the same documents to make these calculations. So the correct  
2 length of the potable trunk mains network, taking all that into account, is less. This is the point  
3 we make on 73, and if you therefore apply the methodology to the correct length of mains to  
4 the potable trunks network, and here we do say that you do need to include in the potable trunk  
5 mains some 300 mm pipes, because not all water travelling from the treatment works, the  
6 potable supply, are in fact as large as 600 mm., some of them are slightly smaller – half the  
7 size. If you take the actual trunk mains, the actual cost per kilometre for potable supplies it is  
8 £28,000 per kilometre. If you do the same exercise using the right volumes for the non-potable  
9 mains, which is only 158 kms (not 700 kms) the figure you get to is 27,000. So in fact, using  
10 the same database that has been used by Albion the conclusion one arrives at is that the potable  
11 and non-potable distribution costs are broadly equivalent, and that is what one would expect.  
12 That is why the Director reached the view that he reached in the Decision. There is nothing  
13 inherently different between potable water and non-potable water when it comes to  
14 distribution. It is widely accepted, that is the way figures are submitted under the regulatory  
15 accounting guidelines, there is no requirement to split them. They would not be different.  
16 A point may be made “Oh yes, but potable supplies are all high pressure, they all require  
17 pumping”. Well, why would that be so? We are talking about large bulk potable and large  
18 bulk non-potable supplies. Unless all the potable users were on the top of hills and all the  
19 non-potable in the bottom of valleys. There is absolutely no reason why pumping would be  
20 different, indeed from our experience in fact the majority of both potable and non-potable  
21 supplies are pumped at some point. The same applies to almost every differential that is set out  
22 or relied upon by Albion. Both potable and non-potable benefit from balancing reservoirs,  
23 flow balancing is needed. Leakage monitoring is needed, flow management data may be  
24 extracted from both. Therefore we say there is simply no basis for this Tribunal to conclude  
25 that the Director erred in accepting the assumption that potable and non-potable supply costs  
26 are not equivalent.

27 That is at the hart then of what is the next two methodologies advanced – one is annex  
28 2 to the skeleton argument. What has happened in annex 2 to the skeleton argument of Albion  
29 is that t hey have taken figures from what has been described as the 1998 LIT submission from  
30 Welsh, part of the voluntary disclosure. Now that exercise was submitted by Welsh to the  
31 Director with a view to seeking the Director’s approval for a large user tariff, not a non-potable  
32 tariff, a large user tariff and the point of it was to seek to demonstrate that as far as large users  
33 are concerned, there are certain costs in the current regime of prices that should be reduced,  
34 because large users are in a slightly different category.

1 THE PRESIDENT: The tariff they finished up with was a large user potable tariff, is that right?

2 MR. ANDERSON: This exercise, yes. Subsequently of course they have introduced a large user  
3 non-potable tariff which is the 26p new tariff I have been referring to and is the new tariff that  
4 is used as the comparator throughout the seven step process – not this tariff. So what Albion  
5 have done in annex 2 is to take the figures submitted in that exercise in 1998 to produce a large  
6 user tariff, and they have taken it a stage further. So you have run these arguments as to why  
7 large users are a special case and need some discount, now let us take it a stage further and  
8 look at the non-potable large users, and we say for various reasons you need to make yet a  
9 further discount or deduction, in some cases 100 per cent. We have not dealt with it in writing,  
10 but the conclusions are to be found in the table at p.59. If I could just explain what we  
11 understood happened with the creation of this table and why the correction that we put in about  
12 75 per cent/25 per cent – you will recall the erratum – we had described these figures as having  
13 been reduced. When I say “these” figures, I am talking about the second column in “Large  
14 potable pence per cubic metre”, which are Welsh – there is the large user tariff not  
15 differentiated between potable and non-potable. We said originally in our skeleton that they  
16 had been reduced by 75 per cent from the figures in the original Welsh submission of 1998.  
17 I got that wrong, I should have said they are 75 per cent. of those figures so far as the direct  
18 costs are concerned. We do not know why Albion chose to take only 75 per cent. It may be  
19 something to do with a difference of treatment between allocating common costs between the  
20 way Welsh have approached it and the way they approach it, but the so-called 21p that  
21 Mr. Thompson indicated yesterday came as a complete surprise to him is simply 100 per cent.  
22 of 16.3 as 75 per cent. The 21p is therefore the consequence of taking what Albion have done  
23 with Welsh’s figures to their logical conclusion. We do not see any reason for doing it, but it  
24 is not an issue that need particularly trouble this Tribunal because at the end of the day the  
25 figure that Albion identify as the distribution total, 16.3 is, give or take a few tenths of a penny,  
26 the same as the 16p distribution figure that has been adopted by Welsh and accepted by the  
27 Director in the Decision. So the issue is, is that 16p distribution cost for potable? Should that  
28 be reduced in relation to non-potable? What Albion have sought to do in the narratives at 6  
29 through to 23 is assert, unsupported by any evidence, that there are a number of reasons why  
30 there should be further discounts in relation to non-potable supplies.

31 THE PRESIDENT: They bring it down to 1.3, under 2p, yes. It is quite a substantial difference.

32 MR. ANDERSON: It is a very, very substantial difference and they have done it by further reducing  
33 practically every item in the table. We could, if it would assist the Tribunal, provide in writing  
34 a line by line rebuttal. We only got this in the skeleton and we would have needed to

1 undertake a little more investigation than time permitted to actually put in a written response.  
2 We can do that if that would assist the Tribunal. But if I could just run through some of the  
3 highlight points as to why we do not accept it. For the record, the Director does not accept  
4 a single one of the assertions set out in that table.

5 The first significant one in which there are changes is really para.8 – “Repair and  
6 maintenance service reservoirs.”

7 THE PRESIDENT: Yes, the reservoirs is the first one on the list ----

8 MR. ANDERSON: Their argument is that service reservoirs do not form part of non-potable  
9 systems and therefore should be discounted entirely. Our short answer to that is that all bulk  
10 distribution systems, potable and non-potable, require flow balancing mechanisms and in some  
11 cases that will be service reservoirs, in some cases it may be achieved by some other means.  
12 But there is simply no logical basis and certainly no evidence advanced to support the  
13 proposition that service reservoirs are of relevance to the one system and not to the other. So  
14 we reject that.

15 Distribution pumping. Again, we do not accept the argument that non-potable  
16 systems are a much lower pressure than potable systems. It may be true that Ashgrove does  
17 not have any pumping, but our short answer to that is “So what?” We are looking at regional  
18 costs of non-potable distribution. So far as we have been able to ascertain in the time it is an  
19 incorrect assumption – the pressure of a system does not depend upon whether it is potable or  
20 non-potable water, it depends on a whole series of factors – it may be customer preference, it  
21 may be the nature of the end use, it may be simply a function of the location of the end user  
22 compared to where the reservoir or treatment centre, it could be any number of reasons, but it  
23 is certainly not referable to whether it is potable or non-potable. Similarly, as I say in relation  
24 to pumping we have been able to ascertain that the majority of all systems are in fact  
25 pumped – potable and non-potable – but again it is not a consequence of it being potable or  
26 non-potable that one system maybe pumped and the other not pumped, it depends on whether  
27 one happens, as a result of local geography, to have the benefit of gravity or not. By-laws – I  
28 think by-laws may be something I need to get back to you on, it is not a huge ----

29 THE PRESIDENT: It is not as significant as some others. What about waste detection?

30 MR. ANDERSON: Waste detection. The point that is made here on waste detection is they use 2  
31 per cent. and they say 2 per cent. for both. So they are arguing for parity but the reason why  
32 the figure is so much lower is because they are arguing for 2 per cent. on such a smaller figure  
33 because they have deducted it for all the other reasons. It is not that there is a distinction to be  
34 drawn, it is just what figure do you apply the percentage to? We say it should be the same

1 figure for both potable and non-potable because there is no reason to distinguish between the  
2 two systems for the purposes of waste management. This is really essentially a leakage  
3 management activity, there is again no distinction to be drawn.

4 The same point is to be made in relation to management. It is a question of what do  
5 you apply the 12.99 per cent. to? Do you apply it to the 4.2 for the treatment aspect of it, or do  
6 you apply it to the much smaller figure of 0.2 per cent., so it is similar to the waste detection.

7 Rates. We do not see any rationale for distinguishing between how one approaches  
8 rates for potable and non-potable customers, bearing in mind we are talking about large potable  
9 and large non-potable customers. This is not a debate about households, this is a debate about  
10 large industrial users, and that is bulk users, that is why there is simply no logical reason for  
11 drawing a distinction between the two.

12 THE PRESIDENT: These are the rates payable on the pipes?

13 MR. ANDERSON: Effectively, yes, Sir.

14 THE PRESIDENT: And a pipe is rated the same whatever sort of water it is carrying?

15 MR. ANDERSON: Exactly. Customer service, paras. 17 and 19, Albion argues that these are  
16 partially avoided. That is really, if you like, an Albion specific argument, it goes back to local  
17 de-averaging. They say themselves have undertaken certain regulatory functions as a result of  
18 their appointment and therefore those should be reduced, so it is a de-averaging answer to that.  
19 Scientific services – they say no scientific services are provided within the non-potable  
20 distribution service. We do not accept that. There are scientific services applicable in relation  
21 to the non-potable system. They may be less, there may be a case for some reduction in the  
22 sense that there might be less actual monitoring of water quality going through the system in  
23 relation to potable water because you need to ensure potable water remains at a potable level,  
24 so there may be a bit of a point there, but the distinction is, in our submission, *de minimis*.

25 Doubtful debts. Again, why should a non-potable large user be any more or less of a  
26 risk for bad debt than a large non-potable user? We are not again talking about the distinction  
27 between householders and industrial users, we are talking about the potable and non-potable  
28 supply in bulk to large users. That, in essence, is what we say in answer to annex 2. They  
29 simply have not begun to make out a case that our assumption was wrong. We have similar  
30 objections as we had under methodology 3 to the exercise Mr. Thompson submitted yesterday.  
31 The argument appears to be that you looked at treatment as between potable and non-potable  
32 and you made the adjustment, 30 per cent down to 15.2 per cent.

33 THE PRESIDENT: Yes.

34 MR. ANDERSON: Because you did that you should have done a similar kind of exercise on

1 distribution. Our short answer to that is “no”. Obviously there are going to be differences  
2 between potable and non-potable when it comes to treatment, not so far as distribution is  
3 concerned. That is the first point in answer to criticism for not having undertaken an exercise.

4 The second point, of course, is that this exercise ----

5 THE PRESIDENT: When we are talking about distribution we are talking about ----

6 MR. ANDERSON: Transport.

7 THE PRESIDENT: -- yes, but we are talking about distribution to large users?

8 MR. ANDERSON: Yes.

9 THE PRESIDENT: We are not talking about household distribution and all that sort of thing?

10 MR. ANDERSON: No, we are talking about distribution to these large users through these very  
11 large pipes, though in some instances, at least in relation to the potable network, they in fact  
12 only ever go through three ----

13 THE PRESIDENT: And you say there is no real difference between potable and non-potable in  
14 this ----

15 MR. ANDERSON: No, there is no reason why there should be any difference. Of course, the other  
16 point to make is that the 30 per cent. figure ----

17 THE PRESIDENT: These calculations that we saw yesterday come back to the aqueduct point to  
18 some extent.

19 MR. ANDERSON: They do, they to some extent come back to the aqueduct point and, as a result,  
20 come back to the same essential difficulty, which is using the 695 kms as the relevant mileage  
21 is inappropriate, because as it happens on that asset inventory return Welsh put everything in  
22 there, they treated it as a residual category that includes, for example, mains for fire fighting,  
23 the sludge main that you saw at Ashgrove, indeed, any pipe which is not a potable pipe was put  
24 into that category. Now, one could argue maybe they should, maybe they should not, the  
25 important point is that that asset inventory is not intended as a vehicle upon which to calculate  
26 any costs or to do any exercise of the kind that Albion has sought to derive from it. There may  
27 even be mains in that category that have no modern equivalent asset value at all because they  
28 are no longer being used. It is simply an inventory of assets, no thought need be given to what  
29 category to put the residual pipes into, certainly for the purposes of the kind of exercise that is  
30 being undertaken here.

31 So the essential issue is can one draw any conclusions from the exercise undertaken in  
32 this further submission put before you yesterday, and the answer is clearly no. It is simply  
33 using information that has been created for an entirely different purpose and cannot be used for  
34 that exercise, no conclusion could be derived from it, so we are back to effectively

1 methodology 3 – is there any basis for concluding that the distribution costs for potable and  
2 non-potable, or the assumption that they are the same, used by Welsh in the methodology they  
3 advance and accepted by us, is that a reasonable assumption? The answer is “yes”, and there is  
4 nothing convincing before the Tribunal that suggests that that assumption is unfounded.

5 I was going to say that is effectively the Director’s case in a nutshell on excess  
6 pricing, it is in fact practically all of my case on it.

7 THE PRESIDENT: Quite a large “nut” I think, Mr. Anderson.

8 MR. ANDERSON: So although there is a great wodge of my skeleton later on that develops all  
9 those points I think I have developed most of them as much as I need. Could I just quickly  
10 now move on to margin squeeze and summarise what we say on margin squeeze?

11 THE PRESIDENT: Yes.

12 MR. ANDERSON: Really, in the skeleton and, indeed, in the Reply *Genzyme* was advanced as the  
13 principal authority on which the Appellant relied to demonstrate it is terribly unfair, we have  
14 got no margin, look at *Genzyme*, the Tribunal said that there should be a margin.

15 THE PRESIDENT: Standing back from the detail of distribution costs, treatment costs and all the  
16 rest of it, it is a general point that we need to get to the bottom of, as it were, this margin point,  
17 because it would appear that on the Director’s approach there is not a margin and one  
18 consequence of that could be, and I think so the Appellants argue, that if that is right there  
19 never will be any scope for intermediaries to operate in this industry, and that would not be  
20 compatible either with the Act or with the intention of the new regime that there should be  
21 some scope for intermediaries to operate.

22 MR. ANDERSON: Well it depends what you mean by an “intermediary”. There is no scope for  
23 margin if an intermediary does not do anything, that is essentially our case here.

24 THE PRESIDENT: We need to understand what the case is and it may be that that is already  
25 something you have clarified that there is no scope and there is not going to be any scope for  
26 the kind of activity that Albion is seeking to undertake here – end of point – end of case.

27 MR. ANDERSON: That is correct.

28 THE PRESIDENT: That is it.

29 MR. ANDERSON: An undertaking in the position of Albion who provides nothing in the way of  
30 alternative sources, nothing in the way of alternative infrastructure, no investment, nothing  
31 other than to interpose itself between the existing supplier and its existing customer, bringing  
32 nothing and relieving Welsh of no activity. In other words, our submission is Albion is not  
33 active in the relevant market at all. That is why there is no margin. That is not to say that there  
34 are no circumstances where a margin would not arise. There may be circumstances where an

1 inset appointee relieves the incumbent of a retail activity. There may be examples where the  
2 inset appointee has obtained an alternative cheaper source from which there can be a margin,  
3 but this is not that case. Now one example might be, for example, in developing a green field  
4 site, there is a new housing development. The inset appointee is going to be producing its own  
5 local distribution network and undertaking its own retail activities but needs an inset  
6 appointment because the housing development is within another undertaker's area. An inset  
7 appointee may take the water from a different source, and needs common carriage through the  
8 incumbent's network to the green field site. In those sorts of circumstances there is plenty of  
9 scope for margin, no doubt scope for competition with the incumbent, but there are situations  
10 where there may be a margin where an incumbent is not having to undertake precisely the  
11 same retail activities that they were undertaking before the inset appointment and the  
12 application for common carriage.

13 THE PRESIDENT: So if I have just understood; there are two circumstances, maybe more, but  
14 there are at least two circumstances in which there could be a margin.

15 MR. ANDERSON: Yes.

16 THE PRESIDENT: The first is where the intermediary, which is a word we will use for want of a  
17 better one for the time being, obtains a cheaper source of water.

18 MR. ANDERSON: Yes.

19 THE PRESIDENT: In which case the Director says he must take his margin out of the cheaper water  
20 price.

21 MR. ANDERSON: Yes.

22 THE PRESIDENT: And it has got nothing to do with the access price that he may or may not pay  
23 that is then calculated.

24 MR. ANDERSON: Yes.

25 THE PRESIDENT: And the second one is where he relieves the incumbent of some function that he,  
26 the incumbent, would otherwise be carrying on.

27 MR. ANDERSON: Yes.

28 THE PRESIDENT: And the incumbent thereby avoids some costs.

29 MR. ANDERSON: Yes, but I ask rhetorically, why should there be any margin in a situation where  
30 nothing has changed other than the identity of the incumbent customer? One requires some  
31 competitive activity to give rise to a competitive consequence, and if we are right that Albion is  
32 in fact doing nothing other than interposing itself between Welsh and Shotton, one cannot see  
33 any logical reason, from competition policy or any other point of view, as to why that mere act  
34 of interposing should generate any margin. Margin should be attributable to an activity, a

1 material activity, a competitive activity. That is what happened in the *Genzyme* case. In  
2 *Genzyme* the competitive activity was in the home care services. Now, what was happening in  
3 *Genzyme* was that the competitor was being charged the bundled price that included the cost of  
4 the drug and the cost of the home care services, 2.95 or whatever it was. That bundled price  
5 prevented the competitor from competing in the downstream market for home care services.  
6 But the point is that, in relation to any patient to which the competitor had interposed himself,  
7 he was displacing the home care services that Genzyme had hitherto been providing and was  
8 replacing itself, and it was in the context of the home care services that the competitive activity,  
9 and hence the margin, was to be generated.

10 The difference here of course is that the interposing of Albion does not displace  
11 Welsh from having to carry out the equivalent of Genzyme's home care services for that  
12 customer. That is why this case is different and why I say, in answer to your questions, there  
13 will not be margin in a case where the new entrant is, to use your term, Sir, bringing no  
14 addition to the value. One can look at it another way: if somebody in the position of Albion  
15 were to be given a guaranteed margin simply for interposing itself, that would be an inefficient  
16 introduction of competition. There would be little incentive to further competitive activity, for  
17 example, to invest in alternative sources, to invest in cheaper infrastructure, if you have a  
18 guaranteed margin simply through the act of interposing yourself. That is why the Director has  
19 serious reservations ----

20 THE PRESIDENT: In other industries, and this case is perhaps a bit obscured by the fact we are just  
21 talking about Albion Water and the Ashgrove system, but in other industries, other network  
22 industries, intermediaries have interposed themselves and what they have been able to do  
23 effectively is to engage in a kind of arbitrage between different sources of supply and different  
24 customers with the result that some customers have got a more competitive price than others,  
25 and if there were ----

26 MR. ANDERSON: Precisely, Sir.

27 THE PRESIDENT: And if there were 50 appellants instead of just one, all of whom were trying to  
28 negotiate on behalf of customers between different water companies in order to get cheaper  
29 water supplies, the look of the case might be a bit different.

30 MR. ANDERSON: Yes, Sir, I agree with you entirely, and you have put, if I may respectfully say  
31 so, your finger on the correct button. What happens in those industries is they source from  
32 alternative upstream sources; they arbitrage. That is how they are able to offer margins.

33 THE PRESIDENT: They do that on the basis, at least I think in gas, but I do not know enough about  
34 it so I will not make any assumptions, but it is all done on the basis that the carriage cost is a

1 sort of objective cost that is worked out perhaps on some average basis, I know not, but the  
2 access price does not vary according to other parameters, it is simply related to the cost of  
3 distribution.

4 MR. ANDERSON: But that is true here. The access price here does not vary according to other  
5 parameters. The access price is the regional average costs of distribution and treatment. Those  
6 are effectively the access price. Now, the question, in principle ----

7 THE PRESIDENT: But just let me go back to my earlier confusion and you will be able to clear it  
8 up for me. If the resource cost of this water had been not 3p. but 15p., to go back to our earlier  
9 example, the working out of the average treatment and distribution costs, plus the resource cost,  
10 would give Shotton a price of approximately 38p. instead of the 26p. that it had.

11 MR. ANDERSON: Yes.

12 THE PRESIDENT: That is how the system works?

13 MR. ANDERSON: That is how the system works, and the access price would have been exactly the  
14 same.

15 THE PRESIDENT: I see; thank you.

16 MR. ANDERSON: And, as I say, the difference with these other markets that you have identified is  
17 all to be found in the upstream trading between alternative sources. That is why I say the  
18 principal situation in which one would expect to see common carriage competition, inset  
19 appointment competition arising, is where somebody comes along to a customer and says,  
20 "I can get you cheaper water", not, "I can go and beat the incumbent about the head and get  
21 him to reduce his access price on treatment and distribution", because those are effectively  
22 fixed. There were two real sources: one is cheaper alternative source of supply, the other is,  
23 for example, and this may be what Albion does under its 70/30 split, to go along to a customer  
24 and say, "I think you waste an awful lot of water in your plant, I can come along and advise  
25 you because I'm an expert in this field. I can advise you how to save water, but I want to split  
26 with you the savings that are derived from that", and there may be money to be made from that.  
27 It does not mean that the cost per cubic metre of the water that the customer is paying goes  
28 down, it simply means that his water bill goes down because he is using less water. But that is  
29 a consultancy service that happens after the water undertaker's supply obligations have ceased.  
30 That is not a margin that is relevant to the debate in this case about a margin for water  
31 undertaker activities. That is the distinction. Those are the two areas where there may be  
32 scope for effectively reducing prices to end users.

33 THE PRESIDENT: I suppose on the 38p. example, if the water price had been 15 and all other  
34 calculations arrived at 38p., the various cross-checks in the Decision would not work - the

1 ECPR cross-checks and the other comparators would not work.

2 MR. ANDERSON: They would in this sense; if in your new world of the 38p. the resource costs  
3 were in fact 15 and not 3p., the chances are that there would be a different large user tariff,  
4 there would be a different second bulk supply price, there would be a different retail price. So  
5 in fact it would all just move up by 15p.

6 THE PRESIDENT: When we are talking about the resource cost are we talking about average  
7 resource costs to all larger users ----

8 MR. ANDERSON: Yes.

9 THE PRESIDENT: ---- or are we talking about the price that is actually paid under these bulk  
10 supply agreements, because I had understood the Decision, at least in part, to work on the  
11 actual prices being paid and not on the average price.

12 MR. ANDERSON: It is local under ECPR and it is average under the regional average pricing  
13 methodology used in the seven step access price.

14 THE PRESIDENT: And is it local under ECPR for treatment and distribution as well or is it just for  
15 water?

16 MR. ANDERSON: There is not a distribution and treatment exercise required under ECPR, because  
17 under ECPR what you have got is a retail price and you deduct from that retail price the costs  
18 you have avoided. We say in a case like this the only costs that have been avoided are what  
19 Welsh has to pay United Utilities.

20 THE PRESIDENT: I see.

21 MR. ANDERSON: So you knock that off, and that is why you get to ----

22 THE PRESIDENT: And the retail price, you are not interested in that – where that local retail price  
23 is concerned you are not interested in how that local retail price is arrived at or what costs it is  
24 supposed to cover.

25 MR. ANDERSON: Yes, because there is ----

26 THE PRESIDENT: You have just got a price.

27 MR. ANDERSON: Because there is a regime in place, s.40 if it is a bulk supply price to settle  
28 things, and if it is not a bulk supply price it will be the large industrial user or a special  
29 agreement which will have been subject to the Director's approval. That is the position here –  
30 the retail price, the Second Bulk Supply Agreement was, we say, agreed by the parties in the  
31 light of an indication the Director had given, an indication the Director had given having regard  
32 to the Hyder International Contract of 28 and six other agreements in the range around 26p., the  
33 long-run marginal cost of bulk supply agreements, because of course the role of the long-run  
34 marginal cost there – and it is a regional long-run marginal cost, is to provide a floor (sic).

1 Bulk supply agreements are normally a balancing arrangement between, for example,  
2 neighbouring water suppliers. They serve a balancing process. This Bulk Supply Agreement  
3 in the case of Albion is a bit of a special case because it is what we would call a brokerage Bulk  
4 Supply Agreement, it is not designed for balancing. But, nonetheless, having regard to the  
5 long-run marginal costs used for the purposes of setting bulk supply agreements by Welsh, that  
6 was 26; the new non-potable tariff was 26. So effectively what the neighbouring company is  
7 paying is the 26p. adjusted for specific reason, namely the use of the lagoons. So there is parity  
8 across -- there is no discrimination. It is not as if Albion are somehow being treated differently  
9 or being treated unfairly, they are being treated in exactly the same way as anybody else in the  
10 situation of buying water from Welsh, whether under the large tariff or any comparison with  
11 the other six. This is not a case of some unfair overcharging to Albion. That is a point that  
12 I tried to make at the outset, but it is an important point to reiterate.

13 THE PRESIDENT: I think it probably is implicit in the Director's position that unless Albion has  
14 got access to an alternative cheaper source or could relieve Welsh of some activity that Welsh  
15 is otherwise undertaking, Albion's inset appointment is effectively without any purpose at all.

16 MR. ANDERSON: That is correct, yes. In the context of this case I am afraid that is the case. That  
17 is a point we have been seeking to make in -- we do not call it bogus or illegitimate. We have  
18 been seeking to identify that this particular business model, from the point of view of seeking  
19 to make any margin on the price between what Welsh charges Albion and Albion charges  
20 Shotton, yes, it is a business model that will never generate a margin. That is not to say Albion  
21 cannot make money out of this arrangement because it could make money out of its  
22 consultancy services.

23 THE PRESIDENT: It would not need an inset appointment to do that, would it?

24 MR. ANDERSON: It would not need an inset appointment to do that, no. It would just come along  
25 and say, "I'm very expertise on water efficiency, consulting services, I could help you save  
26 money", which is effectively what we say are the activities identified in the Decision at  
27 para.348, when was asked them, "What do you do?" Paragraph 348 of the Decision:

28 "We have seen no evidence that the arrival of Albion has resulted in Welsh ceasing to  
29 incur any retail activities. We asked Albion for details of the services it offers to  
30 Shotton."

31 So we are pursuing the points they are making, and this is the response we got.

32 THE PRESIDENT: How do you deal with the point that was made yesterday in the document we  
33 were taken to, that the large user tariff includes these advisory services?

34 MR. ANDERSON: In two ways, and I think it is covered in my rejoinder. Firstly, in the particular

1 instance of this case, the water management, leakage monitoring and so on aspects of it are still  
2 provided by Welsh to Shotton when the system is in place. Indeed I believe Shotton has direct  
3 access to the relevant telemetry hardware without even needing to use Albion at all. So it is  
4 still a service that is supplied to Shotton effectively directly by Welsh, but Welsh can clarify  
5 that if I have got that wrong. I am told that is correct.

6 THE PRESIDENT: But not charged, or perhaps they do charge it?

7 MR. ANDERSON: They do not charge it all because they do not charge Shotton anything.

8 THE PRESIDENT: No, but it is done.

9 MR. ANDERSON: It is an activity that Welsh undertook before Albion came along, and still  
10 undertake. Nothing has been avoided. It is, if you like, paid for by Albion.

11 THE PRESIDENT: Yes.

12 MR. ANDERSON: The other area is water efficiency and so on. That is a very generic activity. It  
13 is actually undertaken I think through websites and leaflets. There is, and never has been,  
14 anything specific to Shotton that Welsh ever undertook. Water efficiency only becomes  
15 important in areas where, for example, there are water shortages, water-stretched areas, but, as  
16 we explain in the paragraph after the one I just showed you, there is nothing that we can see  
17 that Welsh previously provided to Shotton that it no longer provides, and in terms of, as I say,  
18 what is included in the large user tariff, that is phraseology designed to cover all situations. It  
19 covers situations where there may be an actual site-specific water efficiency service, but this is  
20 not such a site. It has never been provided by Welsh to Shotton. So nothing has been avoided,  
21 they have still got their water efficiency advice on their website, they still produce the leaflets,  
22 so nothing has been avoided. That is how I address that point.

23 Paragraph 43 of the rejoinder deals with all those points, because you will recall in  
24 Mr. Malcolm Jeffery's witness statement he refers to things like, "Well, you choose to  
25 interpose a customer relations manager between us and you, it's not necessary". The answer is,  
26 well, "It is, you're still a customer. It may not be Shotton, it's you, you use a large amount of  
27 water, there are problems that arise. You're on the phone to us every day, so we do need  
28 somebody to deal with this account." So it is not choosing to duplicate, it is simply providing  
29 the necessary consequence of nothing changing. Similarly, in billing – all right, Welsh does  
30 not bill Shotton direct, but it bills Albion. Metering – all right, we do not need a meter to see  
31 how much Shotton is consuming, but they need a meter to decide how much Albion is  
32 consuming. So, as I say, that is addressed in those paragraphs of our rejoinder. We cannot see,  
33 and we have asked Welsh and Albion to provide those details, what has been avoided.

34 We do have in Albion's witness statement from Mr. Jeffery a list of statutory duties

1 and obligations arising out of the fact that they are in fact water undertakers, and we have dealt  
2 with that at annex 3 to our skeleton. I will not take you through it all, but the main point to  
3 arise out of it, and we have gone through each of the clauses identified by Mr. Jeffery in his  
4 witness statement, where he says these are obligations imposed upon us. There is a cost  
5 attached to them. This is all part of his justification for the 5p. per cubic metre margin that he  
6 says he needs to be an efficient operator.

7 At footnote 105 at the bottom of p.82 is the point I have just been making about not  
8 avoiding any retail activity.

9 We have then gone through and sought to identify by reference to sections in the Act,  
10 because we suspect Mr. Jeffery was looking at a version of the bill, what we believe he must be  
11 referring to in relation to various duties, and addressed every duty identified in parts A and B of  
12 the schedule to Mr. Jeffery's witness statement, and the short answer is that practically every  
13 one of those duties, or most of those duties, apply either to the pipe work or the infrastructure  
14 of the relevant undertaking, and since Albion does not have any they do not apply to them, or  
15 they are applied in hypothetical situations that are very unlikely to arise, for example, if  
16 Shotton was pulled down and replaced by a housing estate there may be consequences for the  
17 existing inset appointee, but those are all very far-fetched, and some of the others rely on  
18 reporting information and so on, the bulk of which will be based upon information in turn that  
19 has to be collected by Welsh. So it is the statutory duties that are important, not the powers.  
20 The statutory duties that have been identified there are (a) of little practical significance from  
21 Albion's point of view; and (b) have not effectively relieved Welsh of having to undertake the  
22 activities relevant to those duties.

23 I do not know if that is a convenient moment.

24 THE PRESIDENT: I think it probably is, Mr. Anderson. It is quite hard pounding, some of this.

25 Shall we say five past two.

26 (Adjourned for a short time)

27 THE PRESIDENT: Can I just say, Mr. Anderson, that we have received from Aquavita a schedule  
28 of retail activities, which I take it has been served on everybody else, so thank you very much.

29 MR. ANDERSON: I was not proposing to say anything about it ----

30 THE PRESIDENT: Yes, I just wanted to put it on the record that we have had it.

31 MR. ANDERSON: Yes, we have seen it. Technically speaking, in terms of asking you to leaf  
32 through the pages of my skeleton I am still on "the Director's case in a nutshell", but I am not  
33 intending to cover the same ground. That takes me to, I think, around pages 21 and 22, where I  
34 had been dealing with the question of why no margin in this case?

1 THE PRESIDENT: Yes.

2 MR. ANDERSON: Discriminatory pricing and Aquavitae's intervention and the Water Act are the  
3 two principal subjects left for me to cover. I am not proposing to say anything more on delay  
4 since my learned friend did not wish to. Pages 25 and 26 on dominance and essential facilities,  
5 I think it is now common ground that those are irrelevant matters and I am not proposing to say  
6 anything beyond what is there.

7 One then gets to p.27, para.56 where I go back and develop what was in my nutshell  
8 on excessive pricing but, having read through it, I have pretty well covered all the points that I  
9 wanted to make that are set out there, but of course all that is set out there is the Director's  
10 case. So without reading it into the record I just want to emphasise that that is what we say in  
11 relation to excessive pricing.

12 THE PRESIDENT: Could I just ask one question on the approach as it is set out in the  
13 Telecommunications Notice which you refer to on p.28, helpfully. Admittedly this is  
14 telecommunications but probably that the principles are of more general application is  
15 probably not controversial in itself. It says:

16 "Appropriate cost allocation is therefore fundamental to determining whether a price  
17 is excessive. For example, where a company is engaged in a number of activities, it  
18 will be necessary to allocate relevant costs to the various activities, together with an  
19 appropriate contribution towards common costs..."

20 And so forth.

21 "...may also be appropriate for the Commission to determine the proper cost  
22 allocation methodology where this is a subject of dispute."

23 The activity we are concerned with here is essentially the common carriage activity, that bit of  
24 the activity that is related to the common carriage.

25 MR. ANDERSON: Yes.

26 THE PRESIDENT: This is perhaps a rather general question, but one could perhaps imagine a  
27 system in which validly using regional averaging one came to the conclusion that the average  
28 cost of maintaining that bit of the system that was going to be used for the carriage of the water  
29 was whatever, 10p or something, that Aquavitae might look for another source of water, other  
30 than Welsh Water and might find that United Utilities was quite happy to sell the water to  
31 Albion for 10p instead of the 3p it is getting from Welsh Water, making 20p altogether, that  
32 Albion took a turn of 1p on the transaction and therefore charged Shotton 21p instead of the  
33 26p that has turned out by the other method.

34 MR. ANDERSON: Yes.

1 THE PRESIDENT: Would that sort of approach in principle collide with any objective the Director  
2 has or be contrary to any policy or principle that might be relevant in a case like this? In other  
3 words, one is making a more clear distinction between the product we are talking about, which  
4 is the common carriage and the resource, as it were?

5 MR. ANDERSON: No, you are right to make that distinction and I hope I have made clear if I  
6 misunderstood your hypothesis about the 15p rather than 3p. The common carriage in terms of  
7 transport and distribution remains constant in that scenario. When it comes to a water  
8 undertaker, or for example to go back to Professor Pickering's point about the agitating broker  
9 and the scope for negotiation, one has to recall the regulatory framework in which one is here  
10 operating. There are large user tariffs introduced by water undertakers for the supply of water  
11 to customers. Those tariffs are approved annually by the Director under a process that involves  
12 looking at the audited data. There is a prohibition on undertakers discriminating, so there is  
13 limited scope for, if you like, negotiating a departure from the large user tariff.

14 THE PRESIDENT: That is the price that is charged to the customer.

15 MR. ANDERSON: That is the price that is charged to the customer. Strictly speaking in a bulk  
16 supply agreement there is no prohibition of precisely the same kind in terms of bulk supply as  
17 between water undertakers, but in your situation, the situation you are putting to me, you have  
18 effectively identified a cheaper source of water from United Utilities. It is in fact the same  
19 water and one would want to perhaps ask rhetorically why is it that United Utilities would  
20 charge two different prices for supplying the same water at the same cost at a  
21 particular ----

22 THE PRESIDENT: Well on the hypothesis that I have just put to you it is more profitable for United  
23 Utilities to supply Albion because Albion is offering at a better price on the basis that the  
24 average regional cost of the transport are less than this alternative calculation has thrown up –  
25 hypothetically less, I am not saying they would necessarily be less. But you are looking at it  
26 instead of starting from the top with, we call it the cost but it is actually the total revenues, and  
27 then taking out a lot of things to arrive at the bottom.

28 MR. ANDERSON: Yes.

29 THE PRESIDENT: If you started at the bottom with the average cost of the system and just said  
30 “That is the cost, that is the common carriage charge, we will let the water price look after  
31 itself”, you have then got a basis for common carriage to start to operate.

32 MR. ANDERSON: You ought to arrive ----

33 THE PRESIDENT: They ought to meet in the middle, I suppose.

34 MR. ANDERSON: Exactly. There are three elements to the costs – resource, transport and

1 treatment. They ought not to vary, whether one is building up from the bottom or coming  
2 down from the top those are, if you like, fixed amounts that can be separately identified. So on  
3 your hypothesis if there was a 10p common carriage price on your scenario with United  
4 Utilities that will be the common carriage price even if Welsh were to supply Albion.

5 THE PRESIDENT: But on the Director's approach you could say that the transport, and possibly  
6 some treatment costs would be, as it were, a given, depending on what the regional average  
7 was and all the rest of it, but having established that given, then as between water undertakers,  
8 to pick up Professor Pickering's earlier point, there might be some scope for negotiation on the  
9 water price so that the combined package that the end consumer got as a result of the brokerage  
10 activity was an advantageous package to him.

11 MR. ANDERSON: Yes, if Albion were able to negotiate or obtain a cheaper source of water then  
12 there may be scope for margin and competition. Flicking through pages 29, 30, we are merely  
13 referring to our guidance and the main point of merging is the need for consistency. Paragraph  
14 67 and onwards is really ground I have covered. At para.71 I simply refer you to what we have  
15 dealt with in annex 4, the detailed criticisms of what we did with the Welsh methodology and  
16 perhaps just to note in the margin if you also see annex 1 to the rejoinder, it is all brought  
17 together because some of those annexes that were narratives on existing paragraphs can get a  
18 bit indigestible.

19 THE PRESIDENT: Yes, thank you for that.

20 MR. ANDERSON: Paragraph 76, again ground we have covered. The ECPR methodology which  
21 was also taken into account by the Director, resulted in a figure of 22 ½ and therefore in the  
22 round we took the view that overall the access price that had been quoted could not be  
23 regarded as abusive in the circumstances, and that comes back to the question of the Second  
24 Bulk Supply Agreement which, as I say, we were not called upon to formally determine, and  
25 you are not called upon formally to adjudicate on, but nonetheless, and with the cross  
26 references to the Defence I gave earlier (111-120) we have dealt with the criticisms that have  
27 been advanced in relation to the Second Bulk Supply Agreement, which is what we say is the  
28 relevant retail price to be brought in under the costs principle as well.

29 Then I deal with the methodologies which I have been through. There are three  
30 additional points made in the skeleton – I am now at p.40. The point being made is, if you  
31 look at the Second Bulk Supply Agreement for Albion at 26 it is much above four other  
32 examples. I have dealt with two of them, Elan Valley and United Utilities, you are simply not  
33 comparing like with like and effectively the same point can be made in relation to Severn Trent  
34 and Thames Water, they are not comparable. The relevant comparable ones are what I have

1 described as the “selected six” and that is referred to over the page where the price is more in  
2 line.

3 There is then a point made on particular information in relation to the Ashgrove  
4 Treatment Works, and again our principal answer to that is that that is seeking local  
5 de-averaging, which is not the way in which Welsh prices and accordingly not the way in  
6 which it ought to have or should have approached access pricing here.

7 Then annex 2, which is why there should be additional discounts to the large  
8 industrial tariff, I have dealt with.

9 Margin squeeze and *Genzyme* I have been through, and I do not think I need go back  
10 over any of what I have discussed and debated with you this morning on the question of margin  
11 squeeze, but simply draw your attention, at paras.95 to 97, to some examples of where one  
12 might see a margin or a scope for retail competition in addition to the alternative source. One  
13 is the sort of one-stop shop where you agree to supply, to supply a whole range of sites dotted  
14 around the country. It may be if one looks at any particular supply there may not be a margin,  
15 but overall there may be efficiencies in getting all your supplies, for example in billing, from a  
16 single supplier.

17 Price discrimination, para.99. This was not developed this morning, so I do not need  
18 to spend very long on it. We have set out in the OFT guidelines what discrimination is, and  
19 I am sure I do not need to tell the Tribunal what discrimination is. The simple point is that  
20 there is a difference between price differentiation and price discrimination, and what has been  
21 suggested as examples of discrimination here – for example, Elan Valley, United Utilities,  
22 prices are much lower. Those are cases of price differentiation. There are objective reasons  
23 why the prices are different.

24 The next point on discrimination is about treating non-potable water in the same way  
25 as potable water, and that is discriminatory, and I have dealt with that. It is not discriminatory  
26 because they are effectively the same, bearing in mind one is looking at bulk. Of course  
27 differences in treatment, yes, but those were taken into account, and then through 105, 106 and  
28 so on we deal with the technical assertions that are made by Albion in relation to pumping and  
29 balancing and inherently shorter pipelines.

30 Finally, there is the question of the neighbouring company.

31 THE PRESIDENT: Yes, we have not dealt with the lagoons yet.

32 MR. ANDERSON: No, and you did not deal with them with Mr. Thompson on Monday. The short  
33 point about the lagoons is this: it is a service made available effectively to Welsh for the  
34 purposes of balancing the system. You saw at the site visit on the computer screens in the

1 Breton the correlation between the two, so they are in fact used for balancing and I believe  
2 there are logs annexed to Lynette Cross's witness statement, the telephone logs that show the  
3 balancing. We are told that Shotton has on site some tanks that could be used for balancing,  
4 but the reality is they have never been offered for the purposes of balancing and therefore they  
5 are not reflected in any price payable in respect of supply to Shotton. The lagoons are where  
6 the balancing takes place, and that is reflected in the then price to the neighbouring company.  
7 I believe the position now is that in fact that neighbouring company now pays the large  
8 industrial non-potable tariff of 26p. and Welsh separately purchases the service of balancing  
9 the lagoons, but my learned friend Mr. Robertson can clarify that. I am told that is correct.

10 The debate about how much scope there is to balance in the lagoons is not really an  
11 issue that either the Director is in a position to rule on or the Tribunal need, and that then deals  
12 with delay.

13 At this stage I do not propose to say anything more on remedy other than to say we  
14 submit the appeal is ----

15 THE PRESIDENT: No, you do not need to go any further at this stage, Mr. Anderson.

16 MR. ANDERSON: Annex 1 to my skeleton seeks to answer your questions, but I am not proposing  
17 to take you through them. I have covered the ground insofar as I need to. They are fairly self-  
18 explanatory. Questions 1 and 2 are about essential facilities and dominance. Question 3 is in  
19 reference to the guidance, and, yes, the guidance is there; it is not statute, it is guidance as far  
20 as one can take it. The guidance is being updated because the legislative regime is moving and  
21 changing, but there is more detailed guidance on access pricing that the Director General has  
22 issued, and you are taken to it in some detail in the pleadings.

23 THE PRESIDENT: Yes.

24 MR. ANDERSON: Average accounting methods in relation to, particularly, the first bulk supply,  
25 that is the United Utilities agreement and the Elan Valley is all discussed there, the essential  
26 point being that they are different situations.

27 Special agreements. There was a stage at which in this case it was being suggested  
28 that the use of special agreements was a de-averaging when it suited Welsh. It was not  
29 developed yesterday and I do not propose to take you through the point other than to say many  
30 of these special agreements are simply the result of history, pre-privatisation. Now that Welsh  
31 has a large user non-potable tariff they will be migrated to that tariff as and when the special  
32 agreements expire, so I understand. The critical point though to make is the point underlined in  
33 the middle of para.61, that the justification for special agreements is not related to location.  
34 There have to be special circumstances such as the lagoons for the neighbour site, a special

1 service, an increased service, a decreased service or some kind of additional contribution, and  
2 that is all explained on pp.62 and 63.

3 Why are the First and Second Bulk Supply Agreements different? That is question 5,  
4 which I have dealt with.

5 Question 6 is the potable/non-potable debate that I have been through and do not  
6 really need to spend any more time on that. It is really my answer to methodology 3 and annex  
7 2 to the skeleton.

8 Benefit of cross-checks, and what we say there is essentially, well, there is no need for  
9 any further cross-check in this case. We have looked at the methodology, we have looked at  
10 ECPR, we have compared the results with ECPR costs principle, the new tariff, the Second  
11 Bulk Supply Agreement. It is all in line and there is no reason to suppose excessive pricing.  
12 These particular cross-checks, now up to six, that have been advanced do not help because they  
13 are so flawed in so many respects.

14 The 4p. misallocation under the Welsh methodology I have dealt with. It does not  
15 feed through to the second bulk supply price for the reasons I have given.

16 Objective concept, question 9. We only dealt with that because it was alleged against  
17 Welsh, but it is an objective concept.

18 Margin squeeze I have been through.

19 Saving of costs, question 10 ----

20 PROFESSOR PICKERING: Could I just interrupt you. In relation to question 9, the notion of an  
21 objective concept, does that imply or require measurability?

22 MR. ANDERSON: Measurability?

23 PROFESSOR PICKERING: Yes.

24 MR. ANDERSON: May I ask in what sense?

25 PROFESSOR PICKERING: Does one need to be able to put a number – to quantify something for it  
26 to be objective in this sense?

27 MR. ANDERSON: I understood objective in that sense to mean is it – does one look at the effect of  
28 the price and assess it against, if you like, independent objective criteria to determine whether  
29 or not it is abusive, or should one be looking at whether, for example, Welsh deliberately  
30 misallocated costs in order to. But as to at what point does a price become excessive, that must  
31 of course be a matter of judgment arising on the facts of any individual case. The view we took  
32 in this case was that, having regard to the Welsh methodology and the other factors that we had  
33 regard to, an overall figure of somewhere over 20p. was about right, and that was therefore not  
34 sufficient to reach the conclusion that there had been abuse of a dominant position. That is what

1 I mean by objectivity.

2 Questions of role of the inset appointee and duplication in 11 and 12 is really covered  
3 in what I have said under 10, and in para.13, what do we mean by “as they would charge  
4 themselves”, of course water undertakers do not tend to have an independent retail arm so that  
5 the concept of “as they would charge themselves” really in that context means nothing more  
6 than charge under access pricing as you would consistently with your charging policy  
7 generally, and that we hope we have explained in the bit in italics over the page, on p.75.

8 That brings me to the costs principle under the Water Act, and the starting point  
9 I suppose is to turn up the Act itself. 66E.

10 THE PRESIDENT: That is in our authorities bundle?

11 MR. ANDERSON: It is in your authorities bundle behind tab 20 in volume 3.

12 THE PRESIDENT: I wonder if you could take us through not just 66E but 66 as a whole, as it were.

13 MR. ANDERSON: Can I start with 66C because that is the relevant one. Under 66C, and I am not  
14 sure which page it is in your bundle ----

15 THE PRESIDENT: It is p.8.

16 MR. ANDERSON: Under 66C(1)

17 “This section applies where –

18 (a) a qualified licensed water supplier—

19 (i) requests a water undertaker ...”

20 so the water supplier is effectively Albion and “undertaker” is Welsh.

21 THE PRESIDENT: Yes.

22 MR. ANDERSON: So where a supplier asks an undertaker, other than its primary undertaker, to  
23 provide water to the premises of one of the supplier’s customers and requests that primary  
24 undertaker to permit it to introduce water into the system, so that is the situation where it  
25 applies. You are asking for water to be introduced into somebody else’s system on your  
26 behalf. So where that applies it is the duty under, I think it is actually s.66C(2)(b) one moves  
27 to, it is the duty of the primary water undertaker (in this case Welsh)

28 “...in accordance with an agreement or determination for such period ...

29 (i) to take such steps as are specified in subsection (3) below as may be so  
30 provided for in order to enable the licensed water supplier to make the  
31 introduction ...; and

32 (ii) having taken such steps to permit the introduction.”

33 So when the request is made the undertaker in Welsh’s position has to take whatever steps are  
34 necessary to enable that water to be introduced into that supplier’s system. The steps that it

1 takes are those identified in subsection (3), that is effectively connecting. So that is the duty  
2 arising under s.66C, the relevant duty in this case. Section 66D effectively then provides under  
3 s.66D(3) that the charges payable by the water supplier, namely, Albion to the water  
4 undertaker, shall be fixed in accordance with 66E. So where you have a situation where 66C  
5 applies, and there are certain duties on the incumbent to take whatever steps are necessary to  
6 make a connection to enable the water to be introduced, s.66D then sets out the obligation  
7 under how to charge for that common carriage.

8 THE PRESIDENT: Yes.

9 MR. ANDERSON: Section 66E, the costs principle is that the charges payable shall enable the  
10 undertaker to recover two categories of cost. The criticism that is levelled of the Director's  
11 analysis is that it gives no meaning to 66E(1)(a). 66E(1)(a) says in its terms:

12 "Any expenses reasonably incurred in performing any duty under 66A to 66C above,  
13 in accordance with that agreement or determination."

14 We have seen that the relevant duty under 66C is a duty to take the steps necessary to make a  
15 connection. That is the duty to which s.66(1)(a) applies. So what s.66(1)(a) is referring to are  
16 the specific costs effectively of making the connection, what is termed in the industry "the  
17 steps", adjusting the kit. 66E(1)(b) is then the "meat" if you like of the section.

18 THE PRESIDENT: Wait a minute. The duty in section 66C extends beyond the steps, does it not?  
19 It includes, at the end of (b) the duty to permit the introduction of the water.

20 MR. ANDERSON: Yes. Well that is just a licence, a duty, an obligation to allow the water then to  
21 flow through the system. Of course, merely making the connection is not enough, but you are  
22 not going to incur costs in relation to the granting of the permission. It is costs, the relevant  
23 costs are those associated with making the connection. So having made the connection you  
24 then permit the water to be introduced.

25 THE PRESIDENT: The duty is to provide the supply is it not? In A(2) ----

26 MR. ANDERSON: No, the duty is to take the steps necessary to make the connection and then to  
27 permit the introduction of the supply into the system.

28 THE PRESIDENT: I am sorry, yes, it is the duty of the secondary water undertaker to provide the  
29 supply, so that must be included in the – the secondary water undertaker is the other source, so  
30 that must be part of the expenses referred to under 66E(1)(a) when we are dealing with the  
31 secondary water undertaker and, as far as the primary water undertaker is concerned, his duty  
32 is to take the steps and once he has taken the steps to permit the introduction of the water.

33 MR. ANDERSON: Yes, I think I have probably made it more complicated than I need by referring  
34 to 66C, because it may be that 66B is more relevant, which is simply one water undertaker. It

1 is the same principle if one goes to 66B(3), then we can get away from primary and secondary.  
2 THE PRESIDENT: Yes, I think it is useful to try and see it as a whole.  
3 MR. ANDERSON: Yes. 66B(3) ----  
4 THE PRESIDENT: Let us just glance back at 66(A) so we know where we are starting. So that is  
5 where a licensed water supplier requests the primary undertaker to supply it.  
6 MR. ANDERSON: Yes.  
7 THE PRESIDENT: He has a duty to take the steps and to provide the supply.  
8 MR. ANDERSON: Yes.  
9 THE PRESIDENT: The expenses incurred by him – just to take that very first example of the  
10 primary water undertaker – are not just the expenses of connecting the system but making the  
11 supply.  
12 MR. ANDERSON: Yes.  
13 THE PRESIDENT: And then we get through to B, the introduction of water.  
14 MR. ANDERSON: Which is what effectively this case would be because Albion are purchasing the  
15 water from United Utilities, it is therefore not Welsh’s water, they are introducing water into  
16 somebody else’s supply system, so it is either 66B or 66C.  
17 THE PRESIDENT: Just a minute. It is the duty of the undertaker, under (3) to take any such steps –  
18 for the purpose of connecting with the treatment works, connecting with the source and  
19 having taken such steps permits the request for the introduction of the water.  
20 MR. ANDERSON: So in relation to any situation where you are introducing third party water into  
21 the primary undertakers or the undertaker’s water area there is a duty on the incumbent to take  
22 the steps necessary to enable that water to be introduced and then to permit it to be introduced.  
23 THE PRESIDENT: Yes.  
24 MR. ANDERSON: Those, we say, are the duties referred to in 66E(1)(a).  
25 THE PRESIDENT: But not the ongoing expense of maintaining the pipeline through which the  
26 water is flowing?  
27 MR. ANDERSON: Not under that, that ought to have been already included in the retail price that  
28 one will be coming to at a later stage. This is just the specific costs of discharging the duties  
29 under those sections, and the duties under those sections are about connection and introduction  
30 of third party water, not the existing pipeline. The duties under s.66A, B and C are duties –  
31 well at least s.66B and C – concerning connection and introduction.  
32 THE PRESIDENT: But 66A, which is a wholesale water supply includes a duty to provide the  
33 supply?  
34 MR. ANDERSON: Yes.

1 THE PRESIDENT: Well the expenses incurred in providing the supply are presumably fairly  
2 extensive.

3 MR. ANDERSON: That may be the case, yes.

4 PROFESSOR PICKERING: I am not sure whether this is helpful or not, but in relation to 66C, and  
5 recognising that the situation under which Albion is currently operating is different, as I  
6 understand it from that which Albion would prefer to operate under, and if we recognise that  
7 the essential situation presumably is about Albion's aspirations, which is to buy water from  
8 United, have it treated and then transported by Welsh Water on its behalf, then under 66C(1)  
9 would the water undertaker not be United? That is the secondary water undertaker; and the  
10 primary water undertaker would that not be Welsh Water, because Albion wishes to use the  
11 Welsh Water supply system.

12 MR. ANDERSON: Yes.

13 PROFESSOR PICKERING: So the secondary undertaker is United, the primary undertaker is Welsh  
14 Water?

15 MR. ANDERSON: Yes, the primary water undertaker in that scenario would be Welsh, and it would  
16 be Welsh then that would undertake the duty to undertake the steps necessary.

17 PROFESSOR PICKERING: That is right.

18 MR. ANDERSON: We say that is what is being referred to in 66E(1)(a), when it refers to "expenses  
19 reasonably incurred in performing any duty".

20 THE PRESIDENT: So those are the expenses, just to be clear, in taking the steps for the purposes of  
21 connecting the system, or other unspecified steps in respect of the primary water undertaker's  
22 supply system?

23 MR. ANDERSON: Yes. So it is fairly specific.

24 THE PRESIDENT: It is basically the connection?

25 MR. ANDERSON: Yes, that is what 66E(1)(a) is about. One then moves on to 66E(1)(b), "the  
26 appropriate amount in respect of qualifying expenses and a reasonable return on them, to the  
27 extent that those sums exceed any financial benefits." So in addition to the specific costs of  
28 undertaking the connection one recovers an appropriate amount in respect of qualifying  
29 expenses and a reasonable return on that amount, to the extent that it exceeds financial benefits  
30 – I will come back to financial benefits.

31 One then moves to s.66E (2) as to what are qualifying expenses. That defines  
32 qualifying expenses as "expenses that the undertaker has reasonably incurred, or will  
33 reasonably<sup>7</sup> incur in carrying out its functions" read with s.66(1)(2) which then identifies that  
34 the appropriate amount in relation to those qualifying expenses is the amount by which the

1 undertaker reasonably expected to recover from relevant customers. What are “relevant  
2 customers”? Look at 66E(5), “relevant customers” means the customers to whose premises the  
3 licensed water supplier is to make any supply or water in connection with the agreement or  
4 determination mentioned. So in this case the relevant customer is Shotton, and so the question  
5 that is asked in relation to 66E(2) and (3) is what would Welsh reasonably have expected to  
6 recover from Shotton? The answer is 26p., the second bulk supply price, the retail price, the  
7 regulated retail price. In our submission, there can be no other reasonable construction of 66E  
8 than that.

9 It then comes on to the question of what are financial benefits? In our submission,  
10 that is really a sweep up. There may be financial benefits associated with no longer supplying  
11 that customer. For example, it might free up treatment works that become redundant but the  
12 land can then be sold. For example, one might have a commission arrangement with a  
13 contractor and the cost of – giving a discount once one reaches above a certain threshold, and,  
14 as a result of undertaking this further work, one exceeds that threshold and gets the benefit of  
15 the discount. These are hypothetical examples in relation to an act not yet in force, but we see  
16 that as a sweep up because there may be financial benefits associated with not supplying which  
17 do not fall within s.66E(4) which concerns the recovery or the non-recovery of costs which are  
18 avoided or reduced, and clearly in this case the costs that can be reduced may be more than the  
19 water cost paid by Welsh to United Utilities. In this case of course it is not because there are  
20 no other savings made by Welsh, and that, in essence, is why we say Mr. Thompson has got the  
21 construction or Aquavitae have got the construction of this wrong, and that the interpretation  
22 we have set out in the costs principle paper is the only reasonable construction.

23 If you believe there is an ambiguity ----

24 PROFESSOR PICKERING: Just hold on a minute, Mr. Anderson. (After a pause): Mr. Anderson,  
25 66E(1) talks about a licensed water supplier dealing with a water undertaker.

26 MR. ANDERSON: Yes.

27 PROFESSOR PICKERING: Now, 66D, as we have established, talks about a primary and a  
28 secondary water undertaker, and we have established that in this particular case the aspiration  
29 of Albion would be to have both a primary and a secondary water undertaker - yes

30 MR. ANDERSON: Yes.

31 PROFESSOR PICKERING: 66E, how are you interpreting the concept of water undertaker there?  
32 Are you just looking at Welsh Water or are you considering the role of both the intended water  
33 undertakers, because actually it seems slightly odd drafting, that whereas we have been very  
34 precise in talking about who the primary and the secondary undertaker is in D now we just talk

1 about an undertaker in E.

2 MR. ANDERSON: In s.66D(3) of course one is only talking about undertakers, and that is the  
3 principal section that introduces the obligation under the costs principle. It is simply referring  
4 to the licensed water supplier and the water undertaker. For present purposes, the relevant  
5 water undertaker is Welsh and the relevant licence supplier is Albion. So whether it is primary  
6 or secondary, the question is when one is looking at an access price granted by any particular  
7 undertaker, whether they are primary or secondary, the only undertaker from whom common  
8 carriage is sought in this case is Welsh.

9 PROFESSOR PICKERING: Yes, but supply is sought from somebody else.

10 MR. ANDERSON: Yes, but this is concerned with common carriage, not with supply.

11 PROFESSOR PICKERING: Well, is that so in relation to 66C as a whole?

12 MR. ANDERSON: Section 66C is identifying the duties of both, I accept, a primary and a  
13 secondary undertaking in relation to introduction of water into a system. But the reality is in  
14 this case all that is required is introduction by Albion of water it has purchased from United  
15 Utilities into Welsh's system. The question is, how does one approach the price Welsh should  
16 charge Albion for the introduction of that water into Welsh's system. The answer: s.66D says  
17 the water undertaker shall charge in accordance with 66E. If one goes to 66E and 66E says you  
18 can do two things: (1) you can get back any costs you have incurred in having to make a  
19 connection; and (2) the retail minus point, in other words, the amount you would otherwise  
20 have expected to recover from your customer, namely Shotton, which is 26, less any costs you  
21 have avoided, in this case the only costs that have been avoided being the price that Welsh  
22 would otherwise have had to pay United Utilities.

23 PROFESSOR PICKERING: So in applying 66E you are taking no account at all of the actual or  
24 intended role of United Utilities as the secondary undertaker as defined in 66C?

25 MR. ANDERSON: No common carriage is sought from United Utilities.

26 PROFESSOR PICKERING: But supply is sought. Is not supply greater than just common carriage?

27 I think this is the issue that I would be grateful for your guidance on.

28 MR. ANDERSON: Supply is more than common carriage, but it is irrelevant to the application of  
29 this section. It is just purchasing the water.

30 PROFESSOR PICKERING: The section applies to water as well as ----

31 MR. ANDERSON: Insofar as steps are necessary to make a connection, yes.

32 PROFESSOR PICKERING: Because it starts with 66A, which is to do with purchase of the water,  
33 is it not?

34 MR. ANDERSON: If it were the case that Albion needed common carriage from – supposing the

1 Ashgrove system was owned half by Welsh and half by United Utilities, it may well be that  
2 Albion would need an access price from both of them on that part of the supply system owned  
3 by United Utilities and part of the supply system owned by Welsh, in which case if they were  
4 involved right you would need an access price from both to cover that part of the system. If  
5 that is the case s.66C applies to both undertakers in the same way, namely they are both under a  
6 duty to take the steps necessary, and under s.66D draws no distinction under 66D(3) between  
7 the two undertakers, they are both to apply 66E in arriving at that price, and 66E sets out that  
8 you can get back your costs of connection and you can get back your retail price minus any  
9 avoided costs.

10 PROFESSOR PICKERING: But for the purposes of this review by the Director, he has considered  
11 only the trading relationship and the costs incurred by Welsh Water.

12 MR. ANDERSON: He has, but that is not because he has omitted to look at something he should  
13 have looked at.

14 PROFESSOR PICKERING: No, no.

15 MR. ANDERSON: They were only seeking common carriage from Welsh, so there is nothing to  
16 look at in terms of that other relationship for these purposes, other than the fact that Welsh no  
17 longer has to pay the price to United Utilities.

18 That really covers what I was going to say on this Act, on the costs principle.

19 PROFESSOR PICKERING: So again under this system the cost of carriage as a separate amount is  
20 always going to be sensitive to the amount being charged for the water, because, in other  
21 words, if United Utilities was charging Welsh Water 10p. for the water instead of 3p., Welsh  
22 Water would be avoiding a charge of 10p., so the cost to Albion of carrying the water would be  
23 7p. less than is otherwise arrived at under this principle.

24 MR. ANDERSON: Sir, you can look at, as we have set out in our cost principle papers, the  
25 Parliamentary debate as to why this is the route ----

26 THE PRESIDENT: I am not saying it is right or wrong, but just to understand how it works.

27 MR. ANDERSON: The way it works is, yes, you take the retail price and you deduct the avoidable  
28 costs. The avoidable costs may vary from case to case. It is true that the access price that is  
29 then to be offered, as a matter of statutory duty to be offered, is a residual price arising from a  
30 calculation of that kind, that is true, but that is the mechanism, for better or for worse, that  
31 Parliament has decided upon.

32 THE PRESIDENT: I am not saying it is right or wrong, it is simply to understand it. One might  
33 possibly say that it slightly crosses wires in two places: (1) there is a bit of a mix up between  
34 what is a cost and what is a price in the first place; and (2) there is a bit of a mix up between

1 what is the actual cost of the carriage and what is the price of the water, because of the cost of  
2 the carriage cannot actually vary according to the price of the water, the cost of the carriage is  
3 something that is objectively discoverable by reference to regional average costing.

4 MR. ANDERSON: That is correct.

5 THE PRESIDENT: And if that is what the expenses are then you could ascertain them.

6 MR. ANDERSON: That may be a legitimate criticism ----

7 THE PRESIDENT: All I was trying to do was to understand the wretched thing!

8 MR. ANDERSON: I think you have, Sir.

9 THE PRESIDENT: Okay, fine.

10 MR. ANDERSON: If I may say so. Could I just consult?

11 THE PRESIDENT: Yes, please do.

12 MR. ANDERSON (After a pause): Yes, sir.

13 THE PRESIDENT: That is broadly right?

14 MR. ANDERSON: It seems to be broadly right in the sense that nobody behind me can tell me that  
15 it is wrong!

16 THE PRESIDENT: That is comforting to us!

17 MR. ANDERSON: That, I think, completes what I was proposing to say.

18 THE PRESIDENT: That was extremely clear and helpful; thank you, Mr. Anderson. Yes,  
19 Mr. Robertson.

20 MR. ROBERTSON: Sir, I will be considerably briefer because Welsh Water adopts the submissions  
21 that have been advanced on behalf of the Director, and we confine ourselves only to those  
22 additional matters that we can address from our position as Intervener, and I think those are  
23 really confined to two matters on the substantive appeal and one matter on the interim measures  
24 application.

25 On the substantive appeal the first point to make – it is just to go back to the diagram  
26 that was handed out this morning, where the Tribunal observed that there seems to be quite a  
27 large gap between 3p. at Heron Bridge and 26p. at Sealand. The only point we would make is  
28 of course this is one of those industries where the stuff does fall out of the sky. The rain falls  
29 into the River Dee catchment area and comes down there. That is a free input. Most of the  
30 costs in this industry actually are associated with treatment and distribution. Here, as the  
31 Tribunal saw at the site visit, the actual raw material flows past Heron Bridge. You have got to  
32 pay money to the Environment Agency for the right to abstract it, but then it is a relatively  
33 small activity, as everybody saw, pumping out to the point where title in the water passes from  
34 UU to Welsh Water. So we do not find that difference between 3p. and 26p in itself surprising,

1 it is reflective of the structure of costs in the industry.

2 The second point to make on the substance of the Appeal and develop this at just  
3 slightly greater length. From Welsh's perspective, if there are efficiencies to be gained, then it  
4 is in Welsh's interests to exploit those efficiencies. Welsh does not want to see inefficiencies  
5 in the operation of its business, and this is something that we set out in some detail at paras. 2  
6 to 8 of our skeleton for this hearing. I am not going to read those out but just to revisit it in  
7 summary. One of the features of Welsh is its ownership and financial structure. Its parent is  
8 Glas Cymru, a company limited by guarantee. Its primary objective is to deliver services to its  
9 customers at the quality they require and at the lowest possible cost. So as such Glas Cymru  
10 does not have shareholders, it does not pay dividends to shareholders, and financial surplus is  
11 available to be distributed for the benefit of customers, either in the form of surface  
12 improvements or by way of voluntary abatements to the company's price cap, lower bills.

13 In pursuit of that primary objective Welsh has put in place a strategy based on the  
14 harnessing of competitive forces in the market for operator investment services, indeed, over  
15 80 per cent. of its costs, both operating and capital expenditure is accounted for by activities  
16 which have been outsourced to third parties. So in this way Welsh seeks to work with the best  
17 providers the market can offer. That strategy has worked well. Service performance – most  
18 recently, as the Director has found – Welsh is ranked first out of the 10 water and sewerage  
19 companies. As regards its assets, unique amongst all the 22 water companies, Welsh is the  
20 only company whose water supply assets have been graded by the Director as improving.

21 Thirdly, as regards efficiency we have been able to push efficiencies through the  
22 system and start making distributions back to customers in the form of repayments on their  
23 bills, most recently £18 per customer for the 2005/2006 year. We are the only company to  
24 have that commitment to set bills below the price cap allowed by the Director. This strategy  
25 has been endorsed by the credit rating agency Moody's. It is a matter to our benefit because  
26 better credit ratings mean that we have a lower cost of finance and we have a greater ability to  
27 deliver reductions in customers' bills. We are the only water company to have received an  
28 upgrade in our credit rating. So this outsourcing strategy, trying to get improvements in  
29 efficiencies, welcoming all forms of competition that can deliver better value to our customers  
30 furthers our primary objective.

31 Against that backdrop, it is clear to Welsh that what Albion seeks in these  
32 proceedings offers to us nothing in terms of efficiencies. Albion contributes, in the language  
33 of the policy behind the Competition Act, nothing that we can see to overall consumer welfare.  
34 As far as we can see Albion's approach is to attempt to exploit the Act in order to transfer

1 funds from Welsh to Albion without making a single overall contribution to efficiencies or to  
2 consumer welfare. Its inter-position in the Shotton supply chain does not increase efficiencies  
3 as far as we can see under the current Bulk Supply Arrangements, nor would it apply under  
4 common carriage arrangements were it to be able to purchase water from UU. There is no cost  
5 saving that Albion could generate that Welsh could pass on to its customer base, who are the  
6 ultimate consumers.

7 Counsel for Albion submitted yesterday that the Director appears to want competition  
8 to be financed by customers not by suppliers. Actually, the reality is that Albion wants its  
9 business to be financed by the remainder of Welsh's customers. In fact, insofar as it  
10 contributes anything Albion's role adds further potential costs for us because it represents a  
11 greater credit risk for Welsh than would be the case if we were supplying Shotton direct.

12 So in summary, if a remedy were granted as sought by Albion it would do no more  
13 than create inefficient entry as directly contrary to Welsh's primary objective as a company  
14 but, more importantly, it is contrary to the objectives of the Competition Act and of sector  
15 specific legislation.

16 The third submission that I want to make is in the context of interim relief.

17 THE PRESIDENT: Yes, we have not really got on to interim relief so far.

18 MR. ROBERTSON: Yes. Mr. Thompson said that his case was there in writing, yesterday. We set  
19 out our case in writing. Our case is at paras. 30-52 of our skeleton for this hearing. The  
20 additional submission that Mr. Thompson made yesterday was that any order that the Tribunal  
21 made should take into account what he described as the "4p overcharge".

22 THE PRESIDENT: Sorry, what are we talking about now? There is an existing interim order.

23 MR. ROBERTSON: There is an existing interim order which is a discount of the price that they  
24 would otherwise be charged under the Agreement, less 2.05p per cubic metre until further  
25 order. That is the order that is currently in place unless and until varied by the Tribunal. We  
26 do not invite the Tribunal to vary it.

27 THE PRESIDENT: No one has asked us to vary it at the moment, as far as I am aware.

28 MR. ROBERTSON: Well there is an application to vary in the alternative, from Mr. Thompson and  
29 that is set out in his skeleton for this hearing.

30 THE PRESIDENT: Let us just see what Albion's position is on this. Mr. Thompson, are you asking  
31 us to do anything about the existing order?

32 MR. THOMPSON: Well there is a dispute about what it means in the circumstances, which I do not  
33 think was envisaged or debated when the order was made, that Dwr Cymru wishes to put its  
34 prices up. We say that we are not able to pass that price through to Shotton and this will, in

1 effect, undermine the effect of the order, and it should be made clear that Dwr Cymru is in  
2 effect required to maintain the margin in practice pending the outcome of this case. Dwr  
3 Cymru takes the view that this order means that you simply get whatever that figure is and if  
4 you are worse off because Shotton's prices are not going up then effectively that is tough, as I  
5 understand it. We seek clarification that the order is to be interpreted in the sense that we  
6 submit, or alternatively that it should be varied to maintain the status quo pending the outcome  
7 of this case. That is the gist of it. Whereas Dwr Cymru take the view that it does not need  
8 varying and that the status quo is not to be maintained.

9 THE PRESIDENT: Speaking for myself at least, I do not particularly want to get mentally side-  
10 tracked into interim relief when we are trying hard to concentrate on the substance. I would  
11 have thought that it might be better – I am just looking across to my colleagues – that if this  
12 remains a live issue we deal with it separately when we have got to the end of the argument on  
13 the substance, perhaps tomorrow or whenever, if it is a live issue, or if it cannot be sorted out  
14 or compromised, and if it is really being pressed.

15 MR. THOMPSON: I think it is live in the sense that I think this morning Dr. Bryan received a bill in  
16 the increased sum and therefore will be substantially worse off if he has to pay it.

17 (The Tribunal confer)

18 THE PRESIDENT: I think, Mr. Robertson, we would really much rather deal with this quite  
19 separately, in a separate compartment, when we have got to the end of the substantive hearing,  
20 if we need to deal with it.

21 MR. ROBERTSON: Yes, I think I would confirm what Mr. Thompson says, I think it is very much  
22 a live issue between us, and therefore will be dealt with as directed by the Tribunal.

23 THE PRESIDENT: Well then we may have to rule on it, but I do not want to break our train of  
24 thought, as it were, by trying to grapple with it now.

25 MR. ROBERTSON: Well in that case those really do bring my submissions on interim relief to a  
26 conclusion. There is nothing else that I want to say on interim relief. As regards what we  
27 invite the Tribunal to do, well it follows from what we have said that we invite the Tribunal to  
28 reject Albion's appeal and we would invite the Tribunal to do so in robust terms. This is not a  
29 case, we say, of grey areas, although there has been a great complexity of detail. We say this  
30 really is a matter for a black and white CAT decision. It really is not right, and it is against the  
31 consumer interests that a water company such as Welsh should be faced with what have been  
32 lengthy and costly proceedings both before the Regulator and before this Tribunal arising out  
33 of what we submit is a plainly unmeritorious attempt by Albion to exploit the provisions of the  
34 1998 Act for its own financial benefit with no benefit whatsoever to the ultimate consumer, our

1 customer.

2 Those are Welsh's submissions.

3 THE PRESIDENT: Thank you. Yes, Mr. Randolph?

4 MR. RANDOLPH: Mr. President, gentlemen. I feel rather like a Russian doll, the last one in the  
5 doll, everything is getting smaller and smaller, and I am the tiny, tiny one at the end.

6 THE PRESIDENT: Always the most beautiful doll at the end, Mr. Randolph! (Laughter)

7 MR. RANDOLPH: Mr. President, you are too kind! For fairly obvious reasons I have very little to  
8 say. United Utilities came into this case because of well founded concerns, those concerns in  
9 large part were dealt with by counsel for the appellant agreeing not to proceed with the relief  
10 originally set out at para. 217(d) and (e) with regard to the price charged under the First Bulk  
11 Supply Agreement. That was our big concern. There were other concerns obviously and, as  
12 was shown yesterday, it is useful for us to be here, and I hope that the Tribunal has not been  
13 inconvenienced by our presence.

14 THE PRESIDENT: Not in the least.

15 MR. RANDOLPH: Nonetheless, there is relatively little we feel that we can bring to the party, but  
16 we will bring the following. First – a statement of the obvious – we wholeheartedly support  
17 the Director and, indeed, Welsh Water (Dwr Cymru) in their written and oral submissions and  
18 would wholeheartedly endorse what they say should happen, which is that this Appeal should  
19 be dismissed with costs. We do not think the Appeal has any merit at all.

20 The present case is concerned with the access price between fixed and the Second  
21 Bulk Supply Agreement involving Dwr Cymru, Welsh Water and Albion. The First Bulk  
22 Supply Agreement between my client, United Utilities, and Welsh Water is literally further up  
23 the pipeline and does not concern this Tribunal directly. Nonetheless there have been  
24 questions; there have been questions in the list of issues that were helpfully sent out to the  
25 parties. There have been questions today, from Professor Pickering in particular, as to what the  
26 position is or would be, possibly, if there was a change. Well, we say the reality is different,  
27 we are where we are. If a position were different that could lead to different situations with  
28 regard to costs and prices, but we are not there. We are where we are and that is the price, and  
29 that is the reality. There is also the fact, and we ask the Tribunal to bear this very much in  
30 mind, that as I think Mr. Anderson said, for the Director, there are very important differences  
31 between the First Bulk Supply Agreement and the Second Bulk Supply Agreement, so one is  
32 not comparing apples and apples at all.

33 There are two critical differences. We have set these out but I just want to get them in  
34 the record briefly. The terms of the First Bulk Supply Agreement is an old agreement, it is

1 Jurassic to that extent, were agreed prior to the Director's principles relating to charging  
2 schemes and cost allocations. That is important to bear in mind, it all pre-dates what is now  
3 the current policy and obviously pre-dates what will be the policy when the Water Act comes  
4 in. So those principles are simply not applicable to that Agreement and that could explain in  
5 part why there is a very large difference between that and the Second Bulk Supply Agreement.

6 There is also a critical distinction we submit between the two agreements which  
7 underscores, we say, the central fallacy in the Appellant's case. Its case essentially is that the  
8 price that is being charged by Welsh Water is simply too high for it to make a margin, it cannot  
9 make a living and that is wrong, illegal and unlawful. The price it is charged, it compares with  
10 the price charged by United Utilities to Dwr Cymru and they draw adverse conclusions from  
11 that – a terribly small price for us, and a very large price further down the pipeline. But the  
12 two agreements are extremely different not least by virtue of the fact that the First Bulk Supply  
13 Agreement only concerns the supply of water. You have had this told to you before but we do  
14 want to stress this, we are the only party here, apart from Dwr Cymru obviously, who is a party  
15 to that Agreement and we are the supplier, so it is important that we get this across.

16 THE PRESIDENT: Yes.

17 MR. RANDOLPH: It only concerns the supply of water; it does not concern the treatment or the  
18 transport, apart from that very short bit from there, the round circle up to **there**. I did not have  
19 the pleasure of going on the site visit, but I understand that that is some 40 metres, so hardly  
20 any distance at all.

21 THE PRESIDENT: Up to the top of the hill.

22 MR. RANDOLPH: I can imagine it, but sadly I could not see it.

23 THE PRESIDENT: It is quite a beautiful spot.

24 MR. RANDOLPH: I was not allowed to go! There is also a mis-statement in the Notice of Appeal  
25 at para.163, we have set this out in our skeleton, there is no element of profit in our agreement.  
26 I do not need to go into the rationale or reasons for that, it is there, it is an old agreement and  
27 that is the position. Albion say in its Notice of Appeal that we accept that there was such an  
28 element. We do not.

29 THE PRESIDENT: You mean you do not make any money on that?

30 MR. RANDOLPH: No, but that is that. That again does not need to concern the Tribunal as to the  
31 whys and wherefores, it is simply a fact, but it is wrong to say that there is an element of profit,  
32 there is not.

33 Finally, Sir, I just want to touch on something that Aquavitae mentioned in its  
34 skeleton at para.6. It said the following:

1 “Forms of competition, such as common carriage, have, in principle been available for  
2 years but there has been no take-up. Arguably this is because the Director has shown  
3 no inclination to support it.”

4 We say the word “arguably” is quite telling because that statement, we would submit with  
5 respect, is wholly misleading. Far from a nil take-up there have been, and I am happy to h and  
6 out – I am sorry we did not manage to get hold of this earlier so that we could have put this on  
7 some kind of screen, but it is from the website of OFWAT, the Director. (Documents handed  
8 to the Tribunal) It just sets out in very easy to understand form – at least it is easy for me to  
9 understand, so it must be very easy – inset appointments granted, and you can see, I think the  
10 most important column to look at is the inset basis, which is the fifth column along the top.  
11 You can see that the vast bulk of these inset appointments are on the basis of own assets, that  
12 effectively is boreholes or whatever. So this goes back to the discussion the Tribunal was  
13 having with the Director’s counsel earlier today about the rationale and competition. If you  
14 can access your source of water in a different way, and obviously a cost-effective way to you,  
15 then that is going to make a good rationale for your business plan going forward, and insofar as  
16 the inset bases are different from own supply, you will see No.5, Shotton Paper, that is  
17 obviously bulk supply, and then No.7 is Kodak. Kodak is a flip flop because it started off as a  
18 bulk supplier, own asset, with the appointee being Anglian Water, but then effectively bought  
19 itself back, and you can see that at No.10 over the page.

20 I think the incumbent consent moved back. The only other one that is not an own  
21 asset inset basis is No.9, which is Northern Foods, and you will remember from the Director’s  
22 very skeleton, but in particular para.98 of that skeleton, pointing out the essential particularity  
23 of that inset appointment. Effectively they were going to deal with I think all of the customers’  
24 needs, and it was done on that economic basis.

25 But effectively one can see from this, as I say very easily, that not only was Aquavitae  
26 wholly wrong to say that effectively no take up, there is clearly competition here, but also that  
27 the vast bulk of the people who have taken the chance to compete have done so on an own asset  
28 basis, and that we say supports the view that if you want to get into competition on this  
29 particular area one has got to do it on the basis of providing something, and that provision will  
30 be cheaper sources. And it will be remembered by the Tribunal, as stated by the Director, that  
31 it was on the basis that Albion would indeed exploit other sources of water or put in different  
32 piping to Shotton that the inset appointment was granted. Now, that did not happen, did not  
33 turn out to be reality, but it was on that basis that it was granted. So when we go to, “Oh well,  
34 was this inset appointment a complete waste of time”, and I sort of paraphrase badly the

1 President's question this morning, but that is effectively I think what was being said, no. Had it  
2 gone down the path that it was thought it was going to go down then it could have made a  
3 margin, witness all these people who obviously are in business and doing well otherwise they  
4 would not still be there. Had they done that then the position would have been different and no  
5 doubt we would not be where we are today.

6 We say, in short, that competition policy is not there to make poor business plans  
7 better; competition policy is there to protect the consumer and UU submits in this case that  
8 protection has been met.

9 Finally, Mr. President, gentlemen, there was a discussion in terms of technical  
10 understanding on s.66 of the Act. I am instructed that there has been very long consultation on  
11 the meaning of this Act by the industry, and my client has been ----

12 THE PRESIDENT: I am sure the most eminent brains in the world have thought about it.

13 MR. RANDOLPH: I think everybody has been struggling with it, but it may be the Tribunal does  
14 not have to struggle because effectively at the end of the day one has got to be looking at  
15 whether the Director was correct in his analysis, and really, at the end of the day, certainly it  
16 would be difficult for there to be a sort of twin track on what s.66 means, or perhaps the  
17 Tribunal's view of what it means, and then the ongoing working party of what it means. It  
18 would be unfortunate if the two diverged in any meaningful sense, but obviously the Tribunal  
19 has got jurisdiction to determine what s.66 possibly could mean. But there is that point,  
20 respectfully I would put to the Tribunal, to be borne in mind. This has been going on for a very  
21 long time and obviously there are difficulties with the drafting of the provisions, but there we  
22 are.

23 Unless I can assist any further.

24 THE PRESIDENT: No, thank you very much, Mr. Randolph. Mr. Thompson, we are slightly  
25 inclined to rise for a few minutes before you start, unless there is something you want to say  
26 straight away.

27 MR. THOMPSON: No. I think the only issue I might have raised is if we are coming back  
28 tomorrow morning how the Tribunal wants to use its time, whether it wishes to rise and hear  
29 me tomorrow morning or whether it wishes to hear me start now.

30 THE PRESIDENT: I think we have still got a bit of time today, so I think we will start today, but we  
31 will rise for ten minutes just to give ourselves time to think.

32 MR. THOMPSON: That is of course fine by me. I am grateful.

33 (Short break)

34 MR. THOMPSON: Good afternoon again, Sir, gentlemen. I thought that inevitably with a reply at

1 the end of the day one starts in a slightly haphazard order, but since Mr. Randolph's schedule  
2 was at the top of the pile I thought I might deal with that.

3 I think our first point we would make about that is that none of these are in fact  
4 examples of common carriage, and indeed we would submit that they are rather slim pickings  
5 for a privatised industry. Indeed, I understand that four of the examples involving Anglian  
6 Water as appointees that Anglian Water has actually withdrawn from the competitive market,  
7 and I also note that the most recent inset appointment involving own resources, No.8, appears  
8 to have been in 1999, so it does not show a particularly vigorous state of market competition  
9 resulting from the entry into force of this Act. In fact there only seem to be three appointments  
10 and it is pointed out to me that the appointments 10 and 11 are in fact Three Valleys  
11 re-entering, as it were, the market for which it is responsible anyway in North London and  
12 Bedfordshire, so so much for this. We say that it does not show a vigorous state of  
13 competition, particularly in relation to common carriage.

14 The second point is to comment on some, in my submission, rather revealing remarks  
15 made both by Mr. Anderson and by Mr. Robertson. The last two words that Mr. Robertson  
16 uttered were "our customers", and I do not know whether the President recalls that there was an  
17 issue in *Genzyme*, that repeatedly *Genzyme* referred to a number of its customers as "our  
18 customers" until it was pointed out that they were in fact somebody else's customers, and,  
19 likewise, Shotton is in fact Albion's customer; and likewise the Director repeatedly asked the  
20 question, "What is the benefit to Dwr Cymru?", and I think the President very aptly asked,  
21 "What are the views of the consumers?", and I thought it might be appropriate to look briefly at  
22 the views of consumers and, in particular, Corus and Shotton itself, and that is evidenced in the  
23 papers at bundle 2, tab 11. The point I am making is that I think it is said against me that  
24 Albion is doing nothing for anybody, and that if Albion would only withdraw the world would  
25 be a happier and a quieter place, and in this respect it is worth looking at what the two  
26 consumers on this market think about it.

27 First of all, at p.9 of tab 11 one finds the position of Corus stated.

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

31 Having raised this matter with OFWAT they suggested that your company offers a  
32 realistic alternative to the large established operators. Will you therefore please  
33 confirm that you are able to bid for the supply of water to three of our larger plants  
34 situated in Wales ... The existing agreement for the supply of water to these plants

1 expires in the spring of 2004.

2 If you are able to confirm your position with respect to these plants we will take the  
3 necessary steps to open formal discussion and negotiation.”

4 And then from UPM, who is the body responsible for Shotton Paper, a letter to OFWAT dated  
5 the 15<sup>th</sup> October 2003.

6 “When I met with Bob Batey in May this year he presented me with a choice, to be  
7 served by Albion Water as a wholly owned subsidiary of Pennon Group plc or by  
8 Albion as an independent water company managed by the same team that supported  
9 us since 1995. I had no hesitating in making clear UPM’s determination to be served  
10 by an independent water company. I was convinced that Pennon would not wish to  
11 antagonise OFWAT or its fellow water companies by fighting vigorously the greater  
12 supply security and fairer terms for Shotton Paper.

13 As a result of our decision Pennon was committed to hand over at least 50% of Albion  
14 Water to the original shareholders, but I now understand that Pennon has asked for  
15 OFWAT’s blessing on their plans to hand over full control of Albion to the team led  
16 by Jerry Bryan. I wrote to you last year underlying our support for Albion and the  
17 reasons why the partnership of UPM and Albion Water is so important to our UK  
18 operations. I wish to reiterate that support. We are very conscious that Albion is still  
19 the only active competitor in the market and OFWAT has consistently failed to  
20 address issues relating to the price and non-price terms of water. This gives us some  
21 serious concerns about potential conflicts of interest faced by OFWAT. An  
22 independent Albion Water under Jerry Bryan will continue to fight vigorously for a  
23 better and more competitive water industry. That will undoubtedly make OFWAT’s  
24 life more difficult. I am advised that OFWAT does not have the power to prevent the  
25 proposed change of ownership but we are aware it has the power to revoke Albion  
26 Water’s licence.

27 We understand that Pennon’s decision to seek your blessing was prompted by a desire  
28 to avoid blame should Albion Water fail in the future. I have seen the business plan  
29 for Albion Water created by Jerry Bryan and his responses to the 19 questions from  
30 OFWAT. I am very conscious that that plan is based overwhelmingly on the supply  
31 of regulated water services to the Shotton Paper site. I am also conscious that it  
32 assumes a continuation of the current level of support from UPM that allows Albion  
33 Water to cover its costs while it fights for father terms from Dwr Cymru. I wish to  
34 make it clear that UPM is fully supportive of that plan.”

1 In my submission, those are both highly relevant documents when faced with the sort  
2 of submissions that have been made this afternoon by the Director and Dwr Cymru, that they  
3 are the guardians of the welfare of consumers and that Albion is a somewhat artificial inset into  
4 the happy terms that exist at the moment.

5 I would also remind the Tribunal of the terms of the press release which the Director  
6 himself issues in 1997 which, in my submission, is highly relevant to the type of points that  
7 were being made in particular by Professor Pickering about the valuable effects that an inset  
8 negotiator, as it were, could have on achieving what might be called more interesting, or might  
9 also be called fairer, prices in a market of this kind, and in opening the market to proper market  
10 competition, as was at least the nominal aim of this regulator when the Competition Act came  
11 into force.

12 So much by way of introduction and customer's views, and the second issue I would  
13 like to address now is the question of the costs principle. It seemed to me that it is probably in  
14 the Tribunal's mind, it is an important matter, and it seems to me that one can get to the bottom  
15 of this and make it quite clear that the position I advanced in opening is in fact correct and the  
16 Director is in fact quite clearly wrong.

17 If one looks then at tab 20 of the bundle of authorities, bundle 3 – in my submission,  
18 the Tribunal has very helpfully prompted the parties to look in more detail at ss.66A to D in  
19 order to cast light on what 66E may mean, and I think it is appropriate to take it in stages, first  
20 of all looking at 66A(2), which deals with the position where water is supplied. So the simplest  
21 situation, the supply of wholesale by the primary water undertaker, and under 66A(2)(a) are the  
22 steps which I think Mr. Anderson had in mind as the steps required, but then under (b), having  
23 taken any such steps to provide that supply. So the duty is not only to take the steps  
24 preparatory to the supply but actually to make the supply, and so the scope of the duty for the  
25 purposes of 66E(1)(a) quite clearly extends not only to the preparatory steps but to the actual  
26 supply of the water, and, in my submission, that casts very considerable light about how this  
27 was supposed to work, because the effect of Mr. Anderson's submissions is that one would be  
28 entitled to be paid for discharging that duty but then to be paid the retail price in addition, and,  
29 in my submission, that is a nonsense; you get paid twice for the same thing.

30 THE PRESIDENT: But in this situation being dealt with under 66A, would there be a retail price, or  
31 this is just a supply to somebody where you have not necessarily got an existing customer, you  
32 are just supplying some water.

33 MR. THOMPSON: I think in fact it is the position that prevails ----

34 THE PRESIDENT: Or maybe there always would be, I do not know.

1 MR. THOMPSON: As I understand it, the current position as expressed in some fairly vigorous  
2 terms by Mr. Anderson has been that this is a case where we are being supplied with water on a  
3 wholesale basis and he seeks to equate that precisely to a retail purchase, and works out the  
4 appropriate price on that basis.

5 THE PRESIDENT: So you are a 66A(1) case already?

6 MR. THOMPSON: In theory when you have worked out what price we should pay for the honour of  
7 having this water, then we should pay the full retail price under 66E(1)(a), as I understand it, on  
8 the Director's case, and then the appropriate thing is that you pay it again. In my submission,  
9 that cannot be right.

10 THE PRESIDENT: Yes.

11 MR. THOMPSON: If you then look at the position that actually prevails here or, rather, not actually  
12 but would prevail on the scenario we are asked to consider for the purposes of this complaint  
13 and Decision, in my submission, there are in fact three relevant supplies. There is the supply of  
14 water by UU to Albion at Heron Bridge entering the Dwr Cymru system at the water meter  
15 above Heron Bridge, and there is the supply of treatment services by Dwr Cymru at Ashgrove,  
16 the water entering the treatment plant and exiting it again, and there is the carriage of the water  
17 which we have described precisely as a licence for the water to pass through the pipe, which  
18 starts again at the meter, and the water is then carried through the pipe and flows out again at  
19 Sealand, as we saw on our site visit. So there are in fact three relevant supplies.

20 THE PRESIDENT: And that is Heron Bridge to Sealand, is it?

21 MR. THOMPSON: It is Heron Bridge up to Ashgrove, and then down again, but the carriage is  
22 broken by the treatment at Ashgrove treatment works.

23 THE PRESIDENT: Yes, it is the Ashgrove to Sealand carriage.

24 MR. THOMPSON: If we then look at how this works under the Act and how those three services  
25 are to be paid for, one finds first of all in 66C(2) precisely that situation provided for on p.9,  
26 and I think it was agreed that the secondary water undertaker is, in this context, United, and the  
27 primary is, in this context, Dwr Cymru. So the duty of United is not only to take preparatory  
28 steps but also to provide the water, and so the relevant price for 66E(1)(a) is the price of the  
29 water, and again you run into the nonsensical situation where you then get paid again the  
30 appropriate amount based on the retail price, so that United Utilities would be paid twice on the  
31 Director's construction.

32 THE PRESIDENT: Sorry, you will have to go over that last conclusion against, Mr. Thompson.

33 MR. THOMPSON: The duty imposed on United by 66C(2)(a) is, under A(1), to take the steps  
34 which are necessary. It is difficult to see what steps they are. It sounds to me not much

1 different from what it is doing at the moment. The second one is to allow the water to flow up  
2 the hill pumped by its pumps. Those are the two duties – so exactly what it is doing at the  
3 moment – and the expenses reasonably incurred in performing those duties are to be paid under  
4 66E(1)(a).

5 THE PRESIDENT: But under E(1)(a), if we are talking about United Utilities, what they would be  
6 entitled to collect from Albion would be whatever expenses there were plus the appropriate  
7 amount – that is the amount they would be able to recover from relevant customers, and the  
8 relevant customer here would be their customer, i.e. Dwr Cymru presumably. That is their  
9 customer.

10 MR. THOMPSON: I think the supplier in that context would be Albion.

11 THE PRESIDENT: The supplier is Albion.

12 MR. THOMPSON: So where ----

13 THE PRESIDENT: Wait a minute – is that the charges payable by a licensed water supplier to a  
14 water undertaker – supposing you were buying from United Utilities at Heron Bridge. You  
15 would have to pay them for their cost of running Heron Bridge and getting the water out of the  
16 Dee and all the rest of it.

17 MR. THOMPSON: Yes.

18 THE PRESIDENT: Plus the appropriate amount, and the appropriate amount is what they would  
19 expect to recover from Dwr Cymru.

20 MR. THOMPSON: Yes, but that is because you have left out the definition “qualifying expenses”.  
21 That is the bit that the Director does not seem to like, and it is expenses the water undertaker  
22 has reasonably incurred or will reasonably incur in carrying out its functions. So it is a  
23 contribution, on my reading, to its universal service obligations, as I put it. So these are things  
24 independently of this actual contract.

25 THE PRESIDENT: Oh, I see, that is 66E(1)(a) – no, wait a minute.

26 MR. THOMPSON: 66(2) is the appropriate amount which is defined by reference to qualifying  
27 expenses, which are defined at 66E(2), not by reference to ----

28 THE PRESIDENT: So that is the general expenses.

29 MR. THOMPSON: Yes, expenses that are not relevant to complying with the duty of supplying the  
30 water but are to do with carrying out its functions.

31 THE PRESIDENT: Who is the relevant customer under (3) on this scenario? I am not sure that  
32 anyone has really thought about this scenario for the purposes of this section, but maybe they  
33 have. Who is the relevant customer, or who are the relevant customers?

34 MR. THOMPSON: The customer is Shotton.

1 THE PRESIDENT: But Shotton is not a customer of United Utilities.

2 MR. THOMPSON: Relevant customers are customers to whose premises the licensed water supplier  
3 – so that is Albion – is to make any supply of water in connection with the agreement or  
4 determination mentioned in sub-section (1) above. So United in this context did not expect to  
5 receive any such money, or could not reasonably have expected to receive anything from  
6 Shotton. So they cannot receive anything whereas Dwr Cymru perhaps did expect to receive  
7 something from Shotton, so they can.

8 THE PRESIDENT: Maybe in this context there is no appropriate amount because the customer is  
9 Shotton – that is the premises to which the licensed water suppliers make the supply, but as  
10 regards United Utilities, if we are looking at sub-para.3, they could not reasonably have  
11 expected to recover anything from Shotton.

12 MR. THOMPSON: Indeed.

13 THE PRESIDENT: And not unable to recover anything from Shotton as a result of the licensed  
14 water supplier supplying those premises, and they cannot recover from Shotton because they  
15 were never supplying Shotton in the first place.

16 MR. THOMPSON: Exactly, so, in that context, they would be entitled to recover the actual cost of  
17 the supply under 66E(1)(a) of performing their duties under 66C(2) for providing the water. If  
18 one turns back to p.9, you find that United Utilities is under a duty to take the steps required  
19 and then to provide the water, and 66E(1)(a) provides for it to then recover its expenses of  
20 doing that, for performing that duty.

21 THE PRESIDENT: And since the water comes out of the river for nothing ----

22 MR. THOMPSON: But they pump it and they charge ----

23 THE PRESIDENT: ---- all they can recover is the pumping and the ----

24 MR. THOMPSON: Indeed, that is the regime, and, in my submission, it makes perfect sense. They  
25 can recover the costs, and that is why it is called the “costs principle”. They recover their costs  
26 of performing the duty, but, in addition to that, if they reasonably expected a contribution to  
27 their universal services obligations in this context then they are entitled to charge that as well.  
28 But as, Mr. President, you put it to me, in this context United would have no claim on that  
29 from Shotton, and so it would simply be what it says it is, a costs principle. It is difficult,  
30 because it is quite clear that the Director, and apparently other interested parties, with whatever  
31 interests they may have, clearly want to turn this into an ECPR principle, but in my submission  
32 with whatever deference there should be to the Director, a greater deference should be shown  
33 to Parliament, and if that is not what this legislation says, then the Director will have to “lump  
34 it”.

1           The second point, 66C(2)(b), that is the duty of Dwr Cymru, and this is precisely the  
2 position that we have called the transport service, where Dwr Cymru is under a duty to take  
3 the steps required to enable licensed water to introduce the water into the system. Here again,  
4 it is difficult to see that it will be anything because it is the status quo; and secondly, to permit  
5 the introduction of that supply of water into that supply system. I suppose one could take the  
6 formalistic position that, having allowed it to be introduced, you would exhaust your duty. But  
7 in reality, in my submission, as Mr. Anderson in fact very fairly put it, this is effectively a  
8 licence to allow the water to pass through the pipe, and there is no suggestion that you could  
9 discharge this duty by allowing it to come in and then immediately stop it and push it out  
10 again. The obvious suggestion is that the water is permitted to flow through. That is, in fact,  
11 all that is being done when you are in a common carriage position, simply the water flows  
12 through the pipe.

13 THE PRESIDENT: So to permit the introduction of that supply would include provided and  
14 maintaining the pipe?

15 MR. THOMPSON: It would allow the water to flow into it and in due course to flow out of it, but  
16 that is separately provided for in the other parts of the legislation. Again, when one looks at  
17 66E(1)(a) that makes perfect sense, what are the expenses reasonably incurred in allowing  
18 effectively water to flow through your pipe system, and that is provided for. Then in this  
19 context there would be an appropriate amount, namely a contribution that Dwr Cymru might  
20 previously have expected to recover from Shotton as a contribution to its universal service  
21 obligations, as I think it was put in Parliament.

22 THE PRESIDENT: So for example, and I do not know if this is a relevant example or not, you look  
23 under A at some kind of measure of what you are actually incurring by way of expenses to  
24 provide for the introduction of the water and its carriage through the pipe – it does not involve  
25 in this case pumping, but it could involve pumping and various other things.

26 MR. THOMPSON: Indeed.

27 THE PRESIDENT: And under B I suppose, insofar as all those expenses were below the regional  
28 average for treatment and distribution, you would bring in (or might bring in) a sort of general  
29 overhead charge that is related to those functions. Is that what you are saying?

30 MR. THOMPSON: Well you might do that. I do not think it is determined how the reasonable  
31 incurring of expenses is to be worked out and it is obvious that the Director would have an  
32 important role in determining how you calculated reasonable expenses, for example, for the  
33 purposes of allowing water to flow through a pipe.

34 THE PRESIDENT: So the underlying idea is that you can recover from the licensed water supplier

1 the same kind of contribution to general overheads that you would have expected to have  
2 recovered from the original customer?

3 MR. THOMPSON: Yes, indeed, that is why the appropriate amount is described in such terms, that  
4 it is, as it were, the additional amount that an incumbent water undertaker, with public law  
5 duties to perform its functions, that it incurs them in addition to the narrow contractual costs of  
6 performing this particular contract, and what is required is that the supplier in this context  
7 should make a contribution to those general costs, as you might put it, in addition to the narrow  
8 contractual costs identified under 66E(1)(a).

9 If I may then look at the third stage, the treatment. There is a specific provision for  
10 that in 66B(2) to (3) on p.5, which applies

11 "...where a water undertaker agrees to permit a qualifying licensed water supplier to  
12 introduce water into the undertaker's treatment works."

13 Again it is in the same form, it is somewhat more complex in (3)(a) and (b). There is a  
14 provision for taking steps but then in (b): "Having taken such steps to permit the requested  
15 introduction of the water into that system." In my submission, just as a licence for the water to  
16 flow through the pipeline is obviously implicit in allowing the water into that pipeline into the  
17 first place, likewise, letting the water flow into your treatment system necessarily involves  
18 providing the treatment, because otherwise it is difficult to see what the sense of letting the  
19 water in in the first place is. So again, 66E(1)(a) makes perfect sense that having discharged  
20 the duty of allowing the water into the treatment works you are entitled to recover the expenses  
21 of allowing the water into the treatment works, so a share of the costs of those works, and  
22 likewise again you are entitled to the appropriate amount as defined by 66E(2) and (3). In my  
23 submission that is really extremely clear that that is what the legislation means. It is a case of  
24 something being quite complicated, but once one has mastered it it is reasonably clear.

25 THE PRESIDENT: At the risk of getting it completely wrong, Mr. Anderson will jump up and  
26 correct me if I have got it wrong, the Director's approach I think is that the appropriate amount  
27 under 66(3)(e) in this case is the price that Welsh Water would have recovered from Shotton  
28 less the cost of the water that it has bought from United Utilities. In other words, he takes the  
29 view that the whole of what he would have recovered from Shotton other than the water is  
30 qualifying expense for the purpose of subsection (2).

31 MR. THOMPSON: Yes, I think that is right, but it leads into the problem that on any reasonable  
32 construction of 66E(1)(a) he gets paid twice for doing the same thing.

33 THE PRESIDENT: Yes.

34 MR. THOMPSON: There is, in fact, another point I would like to make about 66E, because as I

1 understand it, and it is a point that was made, not only the Director in this case, but I think also  
2 by the intervener in the Thames case, that this somehow will push the Competition Act out and  
3 this will simply be a statutory regime which you apply regardless of the competition rules. In  
4 my submission on any view that is plainly wrong, because it requires construction of the words  
5 “reasonably expected” in 66E(3)(a) to mean reasonably expected even if the price comprises a  
6 margin squeeze, or even if the price is an abusively excessive price. In my submission the  
7 Director cannot get off the hook of his Competition Act duties by assuming that whatever is  
8 the current price is not excessive and does not constitute a margin squeeze. In my submission,  
9 a monopolist who is charging an abusively excessive price or a margin squeeze cannot  
10 reasonably expect to recover that money, because it must be assumed that in due course a  
11 regulator will put a stop to it. So in my submission, even on its terms, this is not a regime  
12 which will effectively require the Competition Act to be ignored.

13 THE PRESIDENT: So “reasonably expected” cannot extend to recovery of a price that was illegal  
14 in the first place as a result of the Act?

15 MR. THOMPSON: Indeed. Another point that has actually just been made to me by Dr. Bryan is  
16 that on the Director’s construction it appears that, of course, United Utilities is not currently  
17 charging a retail price, so it is not clear whether United Utilities would be entitled to be paid  
18 anything for the discharge of its duties under 66C(2)(a) apart from the set-up costs, which  
19 appears to be zero. So even on its terms it is a problematic construction.

20 MR. ANDERSON: We would agree with that last point.

21 THE PRESIDENT: I am sorry, Mr. Anderson. In theory at least under this Act, Albion could come  
22 to United Utilities and say “Can we have some water, please?” and United Utilities would have  
23 to say “Yes” and what they could recover would simply be the set-up cost, the cost of Heron  
24 Bridge, and that is that.

25 MR. ANDERSON: What they could recover under this Act, yes, would be the set-up costs, and they  
26 would be recovering that under 66E(1)(a), they would be recovering nothing under 66E(1)(b)  
27 because they are incurring no qualifying expenses because Shotton is not their customer, so  
28 they would still be able to charge for the water, not under the Act, but pursuant to an agreement  
29 between them for supplying the water. I am told that is wrong! [Laughter]

30 THE PRESIDENT: Shall we park that part of the discussion for the time being? It underlines that  
31 there are some difficulties in making sense of some parts of this particular section.

32 MR. THOMPSON: Certainly on the Director’s case it is not easy to make any sense of it, but I do to  
33 take that as a reason to reject my interpretation.

34 THE PRESIDENT: Yes.

1 MR. THOMPSON: I see the time, and that is a sort of discrete topic, I do not know whether there is  
2 anything else that the Tribunal would like to raise with me or hear from me in the next 10  
3 minutes or so.

4 THE PRESIDENT: That is a convenient moment from your point of view?

5 MR. THOMPSON: It is a convenient point for me, yes.

6 THE PRESIDENT: Yes. The only matter in my mind is how we deal with this interim measures'  
7 point? I think if it cannot be resolved overnight – and perhaps it can be, I just do not know – I  
8 think we will have to deal with it at the end of the argument tomorrow, probably.

9 MR. THOMPSON: If I may just say on that, we do find it a slightly curious situation. An interim  
10 order was made last Summer to preserve the commercial position of my clients. Dwr Cymru is  
11 a large commercial enterprise and what is in fact a relatively small amount of money would  
12 make a considerable difference, because the effect of Dwr Cymru's change of policy is to cut  
13 our effective margin very substantially, as Dr. Bryan has made clear in his witness statement.  
14 If we have to argue about that then so be it. Our submission is that it is in itself a highly  
15 regrettable commercial decision for Dwr Cymru to make, and for the life of us we cannot see  
16 why it is worthwhile to make it for the few months of what is a relatively small amount of  
17 money for Dwr Cymru but which is a relatively large amount of money for my client. But that  
18 is really a matter for Mr. Robertson to explain why it is that Dwr Cymru has decided in all the  
19 circumstances of this case to press what is for it a rather small commercial point in the context  
20 of this litigation.

21 THE PRESIDENT: Well perhaps you can have a word with each other overnight to see if there is  
22 some middle ground that can be arrived at. Very well, we will say 10.30 in the morning.

23 (Adjourned until 10.30 a.m. on Wednesday, 11<sup>th</sup> May 2005)