IN THE COMPETITION APPEAL TRIBUNAL

Case No. 1046/2/4/04

Victoria House,
Bloomsbury Place,
London WC1A 2EB

6th June 2006

Before:
SIR CHRISTOPHER BELLAMY
(The President)

THE HONOURABLE ANTONY LEWIS
PROFESSOR JOHN PICKERING

Sitting as a Tribunal in England and Wales

BETWEEN:

ALBION WATER LIMITED — Appellant

Supported by

AQUAVITAE (UK) LIMITED — Intervener

-v-

WATER SERVICES REGULATION AUTHORITY — Respondent
(Formerly The Director General of Water Services)

Supported by

DWR CYMRU CYFYNGEDIG
and
UNITED UTILITIES WATER PLC — Interveners

Transcribed from the Shorthand notes of
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HEARING DAY FIVE

APPEARANCES

Mr. Rhodri Thompson QC and Mr. John O'Flaherty, instructed by Albion Water Limited appeared on behalf of the Appellant.

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

Mr. Rupert Anderson QC and Miss Valentina Sloane (instructed by the Head of Legal Services, Water Services Regulation Authority) appeared on behalf of the Respondent.

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

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

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MR. THOMPSON: Good morning, Mr. President, good morning gentlemen. What I was proposing to do was to deal with four issues:

(i) some introductory points, including the points raised last night.

(ii) issues of evidence,

(iii) the specific issues in the case; and

(iv) very briefly the issue of possible remedy although that is obviously not for today.

In terms of introductory points I should say by way of housekeeping that the Tribunal will be aware that Mr. O'Reilly raised the question of tomorrow morning. I now also have a Judgment on the interesting question of whether it is an abuse of dominant position to limit the size of logos on tennis shirts at Wimbledon, which is at 10 o'clock tomorrow. I was just told this very recently, and will obviously clarify the position at lunch time.

THE PRESIDENT: Well we can make arrangements to sit whenever is convenient tomorrow morning, if you want us to sit a bit later.

MR. THOMPSON: In relation to the other housekeeping matters, the Tribunal should have received by email, I hope, a copy of a possible amended pleading – I have hard copies here if necessary.

THE PRESIDENT: No, we have received that, thank you.

MR. THOMPSON: I understand from Mr. Vajda that there may be a question about the references to Corus and whether or not that is confidential. I had not anticipated that to be confidential because it is referred to in the Judgment I handed up yesterday – I do not know if there are any points Mr. Vajda wants to raise on that.

MR. VAJDA: Very briefly, I was instructed that there was a point about confidentiality in relation to Corus but Mr. Thompson has pointed out that in fact those sites are mentioned in the Judgment of Mr. Justice Hart, and so I think now is in the public domain.

THE PRESIDENT: It does look as if it is in the public domain, yes.

MR. VAJDA: I do not, unless the President wants me to, take time up now, but I would like to record my opposition, and I can obviously address the Tribunal when appropriate, to 183G and 183 H – I do not consent to those amendments being made.

THE PRESIDENT: Well, we will look at it *de bene esse* for the time being, Mr. Vajda, thank you.

MR. THOMPSON: I am grateful for that indication. In broad terms what I tried to do in the pleading is deal with the principal points of new evidence which have emerged which appear to me to be material to the issues before the Tribunal without getting involved in a

very cumbersome re-pleading exercise which, in my submission, would not be appropriate given the amount of – if I may say so – water that has flowed under the bridge since July 2004.

THE PRESIDENT: These metaphors are always coming to mind in this sort of case, are they not – "upstream" and "downstream" being a notable one. But in general terms, Mr. Thompson, we fully understand why you make the point, but it is a bit difficult for us to go into Welsh non-potable 8 as it now is, and why that is a low tariff, without having quite a lot of evidence about the background to that.

MR. THOMPSON: Yes, if I may just say on those two points ----

THE PRESIDENT: Similarly with Corus, except insofar as it relates to Ashgrove.

MR. THOMPSON: Yes, I think the reason I have put it in is partly because they are facts that are on the papers, and partly because it is material to the question about how far the new regime of homogenised new tariffs is really an uncontroversial feature of this case – which I think is something that ----

THE PRESIDENT: I suppose you can point to the fact that apparently in the Corus case it is contested and in at least one other case it has not been applied.

MR. THOMPSON: Yes, so that insofar as it is said that the new tariff, as it were, sorts all this out, in my submission these facts are quite notable.

THE PRESIDENT: I see.

MR. THOMPSON: The two points that were raised yesterday at the close were the issue of dominance and the issue of s.66(e) and I think it is appropriate that I take those up front.

THE PRESIDENT: Yes.

MR. THOMPSON: As I said in opening, we made certain points on dominance in our 2005 skeleton argument. In our submission there has been no effective response and to our way of thinking the points are somewhat elementary and really do not admit of any effective response. In relation to the history of this case the Tribunal will bear in mind that the Authority devoted quite an amount of time to this issue in 2002, 2003 and indeed produced a draft Decision on the question of essential facility which is, in a sense, only an extreme form of the dominance question. There are certain new points that crop up in the evidence produced by Dŵr Cymru from time to time about the feasibility of boreholes being used for at least some of the supply, but in my submission the reality here is that there are only three options open to Shotton Paper as alternatives to the present situation:

(i) some form of alternative supply from Dŵr Cymru which would not take the matter any further in my submission,

(ii) some sort of desalination of water out of the sea effectively, or out of boreholes which are proximate to the sea; or

(iii) possibly the alternative pipeline issue which was obviously explored in the Decision and in the earlier Decision.

In relation to the third of those options which appears to be the only one that has really been pursued with any detail we note that Mr. Randolph's cross-examination on day 3 (p.45-46) was to the effect that that was entirely speculative and he said that on behalf of United Utilities, who is the only obvious alternative supplier. So, we say that in those circumstances there is no basis to imagine that there is any short-term alternative to the current monopoly supply, and we do not consider that any further evidence is necessary or appropriate for that matter to be determined. We obviously reserve our position if any new arguments or evidence were advanced, but it appears to us that the answer on this question is really plain and obvious, and however much time Dwr Cymru or the Authority were given, the answer would remain plain and obvious. We obviously, from our point of view, the points we have made already in relation to delay in resolving this case ---- in our submission, that is something that the Tribunal should bear very much in mind in addition to the very substantial strain on resources that conducting litigation of this kind on this scale is imposing on a company of the size of Albion. It does appear to us that the nettle must be grasped at this point – that this is a massive, dominant firm facing marginal entry by a very small one, and that the issue of dominance needs to be addressed. So, that is our submission on dominance.

In relation to Section 66(e), as I said in opening, we made our position pretty clear at the last hearing. The only points that I think we would note is that there have been changes of circumstances since the last hearing – in particular, there is unchallenged evidence from Mr. Jeffery in his second statement as to the circumstances surrounding the adoption of the ECPR model and the Section 66(e) construction adopted by the Authority. There is also, now, admissions, including by the Authority's own expert, of actual inconsistency between the ECPR test and the margin squeeze test under Chapter 2 – at least under certain assumptions which we say would bear out here.

So, in those circumstances we say there is absolutely no reason to strain the construction of Section 66(e) in favour of an ECPR construction. Our submission is that the natural reading is, in effect, inequivalent(?) to the solution that Dr. Marshall suggests – that costs should be allocated in a sensible way, and an allowance should be made for the network costs or the universal service obligations. We note in passing that this is plainly a matter of statutory

construction which is not for the Authority to determine, but rather for the Tribunal to determine. Indeed, the case with which Mr. Vajda sought to belabour Dr. Marshall yesterday – the *Iowa* case – in my submission it is primarily authority in the US context, but it is not for the US regulator to construe US primary legislation. In my submission, it is elementary that that is the position under UK law as well. So, that would be my position in relation to Section 66(e).

THE PRESIDENT: You are going to give us those references to Professor Armstrong at some stage, are you?

MR. THOMPSON: Yes, I will.

Turning to the evidence, I propose to go through the individuals who the Tribunal has seen, starting, of course, with Dr. Bryan. In my submission, on any ordinary view, he was a very impressive witness, who gave very open and detailed evidence, both on points of principle and matters of detail. I note that the Authority appeared reluctant to cross-examine him, despite the aggressive tone of their written submissions, and that Dwr Cymru, although they sought to cross-examine him, they made effectively no progress at all, and ultimately gave up on the points of detail in relation to complexity.

Because there was no detailed cross-examination of Dr. Bryan in the event, not all the points were bottomed out. We have noted various points in our reply skeleton argument – for example, in relation to the alleged change of position by Dr. Bryan. That was not really pursued in cross-examination. We dealt with that at para. 23 of our skeleton argument. In relation to stand-alone costs, that was debated at some length, but our position is set out in Section 20 of our reply. I will come back to that in due course. In relation to raw water, that was not really effectively bottomed out. We rely on the points we make at paras. 50 to 56 in relation to the Authority's points on that which were never pursued with Dr. Bryan.

One specific example, which may give an indication of our general perception that the Authority has failed to scrutinise obvious errors in Dwr Cymru's evidence or its own analysis, but has sought to leap on any points in relation to Albion's evidence, and in particular that of Dr. Bryan. This is the one area where I would propose to go into some detail – Methodology 3. That, you may recall, is addressed in the Authority's rejoinder, and then effectively simply copied into the submissions put forward I think on Friday two weeks ago, by the Authority. One finds that in the Authority's skeleton argument. On p.12 you will see Methodology 3, which is the costs recovery point. You will see at the top of the page:

"Costs recovery. This methodology fails to compare like with like. When comparable potable and non-potable systems are used, the methodology shows distribution costs to be broadly equivalent. This methodology therefore supports the decision. This is addressed in the rejoinder in Annex 1 to this skeleton".

So, you think, "Ah! Yes! There's something new in Annex 1 to the skeleton", but then if you turn to that, at paras. 10 and 11 on p.68 it simply refers to the analysis in the rejoinder. If one then turns to the rejoinder ---- There is also reference to Mr. Jones' first statement at para. 72, which is simply the MEA comparison. But, the relevant part is the rejoinder. It is Annexe 2 – Specific flaws in the steps of the Appellant's alternative methodologies. My recollection is that there is some pagination issue. My Annexe 2 starts at p.54. If we go to p.73, and if you turn back three pages, you will find that this is Methodology 3. The relevant step is Step 3. You will see the passage that we are quite familiar with, about the correct length of mains for the potable and trunk mains network. Do you see that, sir?

THE PRESIDENT: As an alternative test to the distribution costs, calculate the costs per kilometre of the network?

MR. THOMPSON: Step 3. Yes. If you go into the next page, on the right-hand column, you will see the Authority saying, "The correct length of mains and potable trunk mains network [and this is on the 600 and 300ml pipeline] is 1834, using the figure from the PRO4 asset inventory. The annual cost recovery under this methodology is therefore approximately £28,464 per km. But then you see the errors that are set out. The length of the non-potable mains is 158 kms rather than 700 kms, well we know that that is wrong by a factor of 50 per cent., that the actual figure is 110.5. Then in the next subparagraph the volume of non-potable water is 27,000 rather than 495,455. That appears to be wrong as well. The figure we have taken is for 2000/01 because as we understood it that was the position that the Director adopted, but I think the same would apply in relation to 2004, if that is the comparison that the Director considers appropriate.

The position for 2000/01 appears in relation to the special agreement information published by the Director, which we have got a copy of and it may be appropriate for me to hand up. On our figures the volumes, at least at that time, were 44,830 – if you see in the left hand column at the bottom, 44,830 – to which one adds the first Albion figure of 6,468.555 which would give a volume of just over 50,000 megalitres. If one then did the calculation on that basis, multiplying by 16p one would come to a total return of 8,207,886 which, if you divided by 110.5 would come to a figure of £74,279.50p so approximately three times the figure for potable water. We note that that is not comparing like with like in that two of

the systems – 2 and 5 – for non-potable water are actually below 300 ml. If you deducted those you would actually reduce the length to approximately 89 kms and, given that they are the smaller systems, you would reduce the volumes somewhat less so that the figure would in our understanding go up to between £85 and £90,000 per km. So I put this forward simply to note that there is a sort of war of attrition going on here and that here should be no assumption that the Authority is in fact correct when it stops, because we have noted on this, and also in relation to stand-alone costs it sometimes seems to stop the music at a position which does not reflect the latest state of the evidence.

THE PRESIDENT: I was under the impression that on the Authority's case the 300 ml pipes had dropped away.

MR. THOMPSON: But they put it forward as a like for like comparison.

THE PRESIDENT: They still rely on the rejoinder, that is true.

MR. THOMPSON: And they still rely on it. As I understood it that was the analysis they were now relying on, methodology 3, but they have not adjusted it for the actual state of the evidence. It may be that there is something Mr. Anderson will wish to clarify in his submissions.

Turning to Mr. Jeffery. In my submission he was a very open and straight forward witness. He was not challenged on his recent statement in relation to ECPR and the costs' principle. In my submission the only matter on which he was challenged was a somewhat unfair challenge to his November 2004 statement in relation to issues that were not within his knowledge and which were, in fact, addressed by Dr. Bryan. So in my submission there is no reason not to accept his evidence.

In relation to Mr. Hope, who was the only witness of fact adduced by the Authority, we note that despite the terms of para.4 of his statement he was not prepared to take responsibility for the drafting of the decision, and we note in particular that he admitted that there had been no consultation with the CCWG Eminent Persons Group, or with other regulators after 2000 (p.51 day 2, lines 15-21) that there was no consideration of entry barriers or avoidable costs on the downstream market (p.55-56). The avoidable retail costs in relation to water sale and distribution had not been identified at the time of the Decision (day 2, p.56). He also accepted that ECPR did not ensure efficient entry but merely prevented inefficient entry (p.53.lines 10-12).

In relation to Mr. Jones, our submission would be that he had a surprising lack of grasp of the detail of the case given the terms of his statement and the criticisms that were made of Dr. Bryan's evidence. There were a number of issues where he simply did not seem to be

able to answer what Dŵr Cymru's case really was. He made a number of significant admissions, for example, in relation to the costs of laying urban pipeline as against rural pipeline (day 3, p.19-22). The complexity of urban pipelines involving tunnels and bridges, etc. (day 3, p.23-24) and, in particular, the non-comparability of stand-alone costs as done in his second witness statement with the general approach to pricing and charging of Dŵr Cymru (day 3, p.26-27). In addition, in our submission, Mr. Jones's evidence was quite unconvincing in relation to the alleged distinction between raw and non-potable distribution where he sought to maintain that a pipe carrying raw water was nonetheless to be called "non-potable" and was a different service, despite the self-evident facts of the matter (day 3,p.28-31) and likewise we would submit that is criticisms of Dr. Bryan, in relation to the proper characterisation of treatment at Ashgrove were equally unconvincing and indeed seem to be matters outside his expertise (day 3, p17-19)

THE PRESIDENT: That is the point about the saltation in the pipeline?

MR. THOMPSON: Yes, he said that he was doing it because it was a contractual obligation but he appeared to have no explanation of why else he was doing it, and appeared to treat the views of his customers with disdain, so we did not quite know why he took that view and he did not seem to offer any explanation of it.

THE PRESIDENT: Yes.

MR. THOMPSON: The position of Professor Armstrong, the Tribunal will obviously have well in mind the detailed debates that went forward. In broad terms we would say that Professor Armstrong appeared to have, in our submission, a very theoretical focus on the issue of overall productive efficiency and the need to protect cross-subsidies. The one point, I think, of criticism of Professor Armstrong is that we would say that he substantially overstated his difference of position from that of Baumol and the classic justifications of ECPR. The only real difference seemed to be that the regulated retail price, which would still have to be regulated should have to make allowance for cross-subsidies and universal service obligations, things of that kind. But subject to that variation it still seemed to rely on precise identification of avoided costs and tight regulation of the resale price if it was not going to lead to inefficiencies and monopoly rents being passed through to the purchaser. So there did not seem to us to be any great difference in principle despite what Professor Armstrong said.

THE PRESIDENT: But did he not take a different line on the theoretical reasoning of ours by Professor Baumol, namely, the effect that you are trying to reproduce the conditions that

you would get in competitive market or a contestable market, so you need some sort of condition of contestability, before you can apply the rule in the first place?

MR. THOMPSON: That may be right but in substance it merely seemed to be that although the regulator was supposed to regulate to avoid any over charging he should add in the costs of any necessary political cross-subsidies and universal service obligations so that would be a bit of a plus that should be included in the retail price. But otherwise it seemed to be very much business as usual as far as we could see.

We would say that Professor Armstrong was a very open witness; that he admitted first of all the inconsistency between ECPR and margin squeeze where there were significant fixed costs, for example, he quite openly stated it at day 4, p.2, line 16. He also, in our submission, admitted that the pass through was not limited to cross-subsidies and universal services obligations, but that where there were inefficiencies, monopoly rents, or mis-allocations on either the upstream or downstream market, they would all be passed through.

You will recall there was an exchange between Professor Armstrong and myself (day3, p.15, lines 6-16) – that might be a wrong reference, I cannot read my own writing ----

THE PRESIDENT: Come back to it, Mr. Thompson.

MR. THOMPSON: It is towards the end of the day.

THE PRESIDENT: Yes. We remember the passage – a whole lot of other things get passed through, in the wash, as it were.

MR. THOMPSON: Yes, it was towards the end of my cross-examination. Likewise, he did not dispute, or in my submission he did not dispute that the effect of ECPR could be a skewing of competition against the entrant – you will remember the pack on his back (p.66-68) and likewise he expressly accepted that ECPR could not be used as a cross-check on excessive pricing on the upstream market (p.73, day 3, lines 18-27) In my submission the overall effect of Professor Armstrong's evidence is completely devastating to the Authority's defence of its use of ECPR in the Decision.

First, you will recall paras. 317-323 of the Decision where ECPR is used precisely as a cross-check on excessive pricing, but more generally insofar as ECPR and the costs' principle is interpreted in the same way by the Authority, our submission is that the effect of Professor Armstrong's evidence is that ECPR can only be salvaged as compatible with the Chapter II prohibition, if it is re-written so that it deals with total rather than avoided costs, and we would say that that was not ECPR at all, and it clearly is not the ECPR as known, loved and applied by the Authority. So far as this Decision is concerned, the main point is that ECPR is of no value in relation to an excessive pricing inquiry and indeed we

say that that is a matter that should have been blindingly obvious from the *Clear* case in 1995 where the Privy Council was clearly of the view that excessive pricing required regulation by a different mechanism, and we say that this obvious error shows that the Decision is flawed in this respect.

Turning to the evidence of Dr. Marshall, our submission would be that she is an extremely eminent and experienced regulator with long hands-on experience of introducing competition to contestable parts of a regulated utility and, as such, our submission is that her evidence should be given very great weight. We say that there is very little theoretical dispute now remaining with Professor Armstrong, but the main difference is her detailed grasp of the reality of this process not limited to theoretical efficiency gains. We note that the Authority has not identified anybody from within the industry, or from utility regulation who supports its stance. The Authority's only supporters are the incumbents themselves, consultants instructed and paid for by incumbent and theoretical economists however eminent.

We note that the CCCWG did not endorse the Authority's current approach as MD163 demonstrates and as Mr. Hope confirmed. We note also that Professor Armstrong accepted the inconsistency between ECPR and margin squeeze, subject to the amendments discussed with the Tribunal relating to fixed costs and the additional costs of entry. He also accepted the inappropriateness of ECPR as a cross-check for excessive pricing.

The cross-examination of Dr. Marshall, in our submission, very largely comprised a rehearsal of Dr. Marshall's views. We note, in particular, Day 4, for example – p.41 – the repeated stress on the practical concerns in relation to ECPR which we would submit was an entirely appropriate focus given the nature of the inquiry in this case. We also note that at p.41, lines 15 to 22, Dr. Marshall clearly explained that the practical concerns also reflected perverse incentives for the incumbent to mis-allocate or disguise avoided costs. We would say that the facts of this case give a pretty spectacular manifestation of that risk, particularly in relation to retail costs.

The Tribunal will recall that Dr. Marshall was ----

THE PRESIDENT: You will come back to the retail cots point, will you?

MR. THOMPSON: I will. In relation to Mr. Vajda's cross-examination, that was quite substantially devoted to belabouring Dr. Marshall for failure to give sufficient weight to a single Judgment of an American court – pages 46 to 50, Day 4. We would say that the reliance was quite unfair, and misconceived. There was no reference to the case itself. Looking at the case as it appears in the authorities, it appears to be primarily a case about

the **vires** of the Commission in America to lay down pricing rules, and no specific reference was ever made to the Judgment in the cross-examination of Dr. Marshall as, as we understand it, the FCC had used TELRIC and the Eighth Circuit said that this was **ultra vires**. In any event, Mr. Vajda's cross-examination of Dr. Marshall on this point, suggesting how she should have given weight to this telecommunications case of an American Court of Appeal, was obviously inconsistent with the next line of questioning, which stressed the difference between telecommunications and water. So, in my submission, that took the matter no further, and was perhaps a somewhat unfortunate feature of the cross-examination.

So much by way of evidence. I will obviously come back to the *Iowa* case if Mr. Vajda explains exactly what the point is that he thinks can be derived from it.

Turning to the specific issues, first of all, treatment, then distribution, then stand-alone costs, then retailing, then resources, and then briefly I will touch on the issue of remedy.

Looking first of all at treatment, the issue of the purpose of the treatment I have already touched on. We say that the only positive proposal is that of Dr. Bryan in his evidence and, indeed, in the correspondence that we have seen going back. Mr. Jones dismissed that as novel and absurd, but he could offer no other functional explanation. In our submission, it is a somewhat characteristic ----

THE PRESIDENT: Is this a functional reason for the treatment?

MR. THOMPSON: Yes. He could offer no other purpose for the treatment.

THE PRESIDENT: And prevent the pipes salting up.

MR. THOMPSON: I do not want to be tendentious about this, but we would say that it was somewhat characteristic to dismiss the views of a customer in this way, and that it is unfortunate that he mis-characterised Dr. Bryan's position in 2001 with an ironic reference in his witness statement.

In relation to the CCV/MEA issue, we note that Mr. Jones was unable to explain the calculation. It has not really still been explained, although there are further letters on the issue. It appears to include an element of capital costs, although it now appears that that derives from 1987 rather than 1957. We recall Dr. Bryan's evidence that as far as he can see Mr. Jones' MEA valuation in his witness statement is out of line with Dwr Cymru's overall MEA and that his use of CCV was thus a reasonable approximation to MEA, although I do not think that there is a great issue of principle between the parties on what an MEA is. That was obviously explored at some length in cross-examination.

In relation to the potable/non-potable issue, the Tribunal will recall pages 10 to 12 of the SA tab to our skeleton argument last year, and that Dr. Bryan's position in his fourth witness statement is that the better basis would be to look at the actual comparison between Ashgrove (as we now know it to be) and the other potable works identified in those tables. We now understand that the large comparator used on p.SA11 is in fact some form of dis-aggregation of a single treatment works into two parts. That appears from the further correspondence, I think received on Friday from Dwr Cymru. We have no basis to dispute that. But, it is still the case that there is no explanation of how the costs allocations have been done between the two parts of the works. There is obviously room for error since it is essentially Dwr Cymru's own exercise, and it appears to be a somewhat random exercise to split up two parts of a single treatment works and not really the basis for any very clear dis-aggregation between the two. So, it appears to us that Dr. Bryan's position on this is, on balance, to be preferred, although, as I think the Tribunal recognise, that is not the main area of contention between the parties. The issue of treatment costs is, relatively speaking, a minor issue.

Turning to the issue of distribution, as I have said, the reason we have referred to the Corus and non-pot 8 issue relates to the question of whether or not there is any agreement on a new tariff or a common pricing approach. We note in that respect, in particular, para. 16 of the Judgment of Mr. Justice Hart in the Corus debt action. I do not know whether the Tribunal has had a chance to look at that?

THE PRESIDENT: Yes, we have glanced at the Judgment. Paragraph 16 of the Judgment?

MR. THOMPSON: I am quite wrong. It is para. 15 of the Judgment ----

THE PRESIDENT: -- and para. 16 of what is apparently the defence to counterclaim in that case.

MR. THOMPSON: Yes, setting out the issues raised. In particular, one will see from the start of the Judgment that the underlying issue concerns whether or not the non-potable industrial tariff – paras. 4 to 6 of the Judgment – is compatible both with the undue preference and undue discrimination obligations binding the Director, and also with competition law (as one sees at para. 6). The way it is put here is that there is a series of criticisms made of the classification, and, in particular, there is support at 16.4 for Albion's concerns, and quite specific numbers are given in relation to three of the non-potable works at 16.4.2.1 through to 16.4.2.3. In particular, in relation to Shotton at 16.4.2.2 where a figure of 3.7p is suggested is appropriate by Corus.

THE PRESIDENT: But we do not know anything about the provenance of those numbers, do we?

MR. THOMPSON: No – only what is said there. I obviously cannot rely on them as correct, but I rely on them as showing that there is an issue on that question.

If we now turn to the issue of raw water, you will see how it has been pleaded in the draft. The pleading at 183.F (1) to (7) in effect sets out the point that I put to Mr. Jones in cross-examination – that the effect of the current charging structure is that eight of the ten non-potable customers in effect simply receive raw water distribution, whose regional average cost is 2p. So, one might say that it was appropriate for them to be charged 2p for that aspect. But, if that is right, then they are paying 16p effectively for nothing because they do not receive anything other than raw water distribution. There are only two non-potable customers who do receive what might be called non-potable distribution because it is distribution after non-potable treatment. Of those, one is Ashgrove – to Corus and Shotton, or to Albion. But, in reality that is a raw water distribution network between an active non-potable works and a decommissioned potable works. So far as we are aware, there has been no functional change occasioned by the decommissioning for the Sealand waterworks, and certainly not one that could justify the costs suddenly leaping up by eight to ten times. That leaves then only System S6, which has only 8km of non-potable distribution, as against some 55 – 60km of raw distribution. The looking at that could not possibly lead to an eight to ten-fold increase not only in relation to that customer, but in relation to the regional average for non-potable distribution generally as against raw water distribution. So, we say that this comparison –which now can be really made in quite considerable detail as a result of the evidence in Mr. Jones' first witness statement as now amended by the various adjustments that have been made, and that one can actually see what feeds into the regional cost of non-potable distribution. We say that it is in effect exactly the same as raw water distribution, and there is absolutely no basis why it should be charged at a higher rate than both Dwr Cymru and the Authority appear to consider appropriate for raw water distribution.

As I put to Mr. Jones, the comparison to potable bulk distribution is stark. Potable distribution is a substantial additional service, largely serving the major conurbations in South Wales. As such, it is reasonable for major potable users who use that system to pay a proportionate share of the costs of creating and maintaining those systems. We say that that justification is not applicable at all to the completely separate non-potable systems

which are, in reality, completely divorced from that, and should no more be charged an equivalent rate than the raw water systems which everybody pays on the same 2p basis.

THE PRESIDENT: We have a number of potable customers – well, I can think of two off-hand (one apparently in Hereford and one in Anglesea) – that are not part of those systems.

MR. THOMPSON: That is true. The position of particularly the Anglesea one does appear ---- I am not instructed by him, but if I were him I might wonder why it is that I am contributing to the costs of distribution in Cardiff and Swansea. But, I think that is for another day, sir. I do not think it affects the point of principle that I am making. In relation to the population of Hereford, there is obviously an analogy in that presumably Hereford – as I think Mr. Jones indicates – has a conjunctive use system, though obviously on a smaller scale than Cardiff and Swansea. I think he says, in relation to the Anglesea person, that there is a degree of conjunctive use there, but it is obviously on a smaller scale. But, in my submission that does not undermine the point of principle that I am making, and if there is an injustice in the potable large user, sir, that is for another day.

THE PRESIDENT: Yes.

MR. THOMPSON: Turning to the issue of costs, and the notorious paras. 300 to 302 of the Decision and whether they were adequately reasoned, there is obviously a huge amount of material on that, I do not propose to go through that now. We say that, as I put to Mr. Jones, it is now common ground that urban pipelines are at least twice as expensive as rural and maybe substantially more in, for example, the centre of Cardiff.

THE PRESIDENT: Do we know in what sense one is using the words "urban" and "rural"?

MR. THOMPSON: Sorry, when I say "common ground", using the definitions that Mr. Jones uses in his third witness statement. He accepted in cross-examination that urban construction costs were at least twice as expensive as rural, indeed, the same was true – almost true, it is just under 100 per cent. for semi-urban, but simply using the evidence that Mr. Jones has in his own third witness statement it is common ground that Urban is at least twice as expensive as rural.

THE PRESIDENT: I suppose what I meant was I am slightly unsure whether the term "urban" and "rural" in the third witness statement are actually being used in the same sense as "urban" is apparently used – or was apparently used – by the ordinance survey in the maps.

MR. THOMPSON: Yes, I understand that point.

THE PRESIDENT: It is just a question of clarifying it.

MR. THOMPSON: Mr. Bryan has tried to do it by reference to the "I" and the maps, and gives estimates.

THE PRESIDENT: Well he suggests that what is regarded by the ordinance survey as "urban" would not be regarded by many people as urban, because it apparently covers everything with some structures. But how that feeds into the urban/rural comparison in terms of pipe laying I am not at the moment clear. It is just a question of being a little clearer.

MR. THOMPSON: I understand that, but I think the only alternative analysis – this was put forward, as it were, to discredit Dr. Bryan's analysis on a quasi-scientific basis and so I am simply using that -----

THE PRESIDENT: Anyway, whatever it is ----

MR. THOMPSON: If Dŵr Cymru want to take that position then on that basis I was meeting them on their own terms. Our own terms are actually the evidence of Dr. Bryan who takes a different approach as it were on a more subjective ----

THE PRESIDENT: Anyway, "urban" twice as expensive as "rural".

MR. THOMPSON: Yes, and may be considerably more, and it was common ground that at least on the Dŵr Cymru analysis there is virtually twice as much urban as rural in relation to potable as against non-potable systems. So in my submission that is quite a significant admission because it really undermines the somewhat bland terms of s.300, 302 of the Decision on a fairly fundamental point.

Secondly, it was common ground that Water Inspectorate obligations do not apply to raw and non-potable systems, and that substantial costs had been incurred in relation to meeting those obligations, which was a point that Dr. Bryan made in his statement. The qualification that Mr. Jones made was that these appeared to apply mainly to the small users, but we still rely on the fact that those costs land on the potable desk and do not land on the non-potable desk and, as such, should not be taken into account for non-potable users and reflect a substantial difference between the two systems.

Thirdly, the vexed question of complexity. Our submission is that the substance of Mr. Jones's evidence was to accept that complex systems involving large numbers of junction with tunnels etc., are much more expensive to build than simple rural pipelines and, indeed, both Dr. Bryan and Mr. Jones gave the specific example of the difficulties that would be faced in a new build of the Shotton pipeline itself, the Ashgrove pipeline itself. In my submission one can read across from that that there would be equally difficult problems if one tried to build pipelines through the middle of Cardiff or Swansea.

We say that that is sufficient, even leaving aside the very detailed evidence that Dr. Bryan has given on all these points, where we would support that and would say that it has not been effectively challenged, that paras.300 to 302 of the Decision obviously cannot stand

and we say that the issue is effectively one of quantum. In relation to quantum, we say – as I have already said – that raw water provides the obvious and in effect undisputed comparator that 2p m^3 is the best reasonable estimate of what, in effect, a raw water distribution service costs Dŵr Cymru on a regional average basis. That is the charge that they make to all their customers. On that basis we say that there is an eight to ten fold overcharge and that there is absolutely no basis to allow greater recovery for non-potable distribution to Albion than for raw water distribution to all other Dŵr Cymru customers.

THE PRESIDENT: I think on this part of the case, Mr. Thompson, we are conscious that on the raw water analogy there is quite a large gap between the average accounting cost price, which I think was 19.2 in the Decision and the 4p for which you are arguing. What we would be perhaps interested in knowing in perhaps a little more detail is if you actually took the average accounting cost approach that is in the Decision and you that is where you started on the top down basis – if only because of the time, there may not have been very much in the way of an alternative basis to start from in Dŵr Cymru case – and you started to take off the various things on which you rely, i.e. you make an allowance for urban/rural, you make an allowance for Water Inspectorate, for complexity, etc. and there were various other things, I think in relation to the large industrial user tariff that Dr. Bryan relied on (and presumably still relies on). Where do you get to? In other words, do you meet your raw water analogy at some point or is there some intermediate figure to which you could credibly arrive?

MR. THOMPSON: Well I think Dr. Bryan has sought to do that.

THE PRESIDENT: Yes, perhaps you could just, either now or at some convenient moment, remind us about all that?

MR. THOMPSON: Yes, I think it is really the guts of Annex A to his witness statement.

THE PRESIDENT: Shall we just have a look at that?

MR. THOMPSON: Yes, certainly.

THE PRESIDENT: This is the witness statement which is in our volume 18. I know it is very detailed, but you can probably pick out for us the crucial points.

MR. THOMPSON: It partly leads into the vexed question of stand-alone, because Annex D is what Dr. Bryan calls the 'stand-alone cost analysis' which refers into Annex A, and sets out the specific features that he has done and, as you see, it is based on the LIT. justification. In relation to the detail I think it is paras. 115 and following of Annex A, where he analyses the distribution cost components in considerable detail.

THE PRESIDENT: Just reminding ourselves what is there, there is quite a lot on repair and maintenance – in fact there are several pages ----

MR. THOMPSON: Yes, it is in answer to para.302(i) of the interim Judgment. Dr. Bryan gives first of all an overview and then he works through the components in considerable detail in paras. 115 and following, the specific issues, and then he looks at universal service obligations, cross-subsidy from 151 to 154, common costs from 155 through to 192 – well it is really the rest of the analysis. He also touches on stranded assets at paras. 217 and following. I think it is that whole section from 105 through to the end of Annex A is Dr. Bryan's attempt to answer the Tribunal's questions in relation to the differences between potable and non-potable for the purposes of an analysis analogous to the analysis that Dŵr Cymru itself undertook in relation to potable water in the LIT justification.

THE PRESIDENT: Yes. Where is that put in issue by ----

MR. THOMPSON: Well there is the witness evidence of Mr. Jones (3rd witness statement). Then there are the skeleton arguments, particularly the skeleton argument of the Authority, which essentially assaults Dr. Bryan's credibility in various respects. I think that is the gist of it but obviously Mr. Vajda and Mr. Anderson can speak for themselves about why they say this is all wrong.

THE PRESIDENT: Yes.

MR. THOMPSON: I was going to turn now to the issue of stand-alone costs and in particular OFT414 and 414A. I do not think we have actually looked at those, so it may be worth just turning them up.

THE PRESIDENT: Where are we likely to find them?

MR. THOMPSON: Do you have a bundle of authorities? It is in the third bundle of authorities.

THE PRESIDENT: Yes.

MR. THOMPSON: I hope yours were not recast for the *Thames* Appeal. I had an entertaining afternoon putting the things back in the right boxes, but I hope that yours were kept in the same state. It should be tabs 15 and 16 in bundle 3, although I did not have a 414 when I came to look at these papers. I hope you have one.

THE PRESIDENT: Well we start with tab 16 in this – we have OFT 414 and at tab 16 we have OFT 414A.

MR. THOMPSON: I am grateful. If we look first of all at 414. I think the first reference is 2.16, they are looking at the issue of supra-normal profits, p.10 of the document. Under the heading "Measuring supra-normal profits". The OFT says:

"An alternative to the two approaches to estimating supra-normal profits referred to above is to look at the stand-alone costs of the activity in question. The stand-alone costs of an activity is the least cost which would be incurred by a hypothetical efficient undertaking supplying only that product or service from a fully utilised plant of optimum size. The revenues of an undertaking significantly and consistently exceeding its stand-alone cost in a particular activity may indicate that excessive prices have been charged. The stand-alone cost will, of course, have to include an appropriate allowance to the undertaking's cost of capital as described above. In regulated sectors the regulator may already possess some of the cost information needed to calculate an activity's stand-alone cost."

Then p.50 includes a definition of stand-alone cost - there is a glossary – it says:

"The lowest cost which could be faced by a hypothetical supplier of only a particular product or service stand-alone costs include all common costs."

Then this, 414 was, I think, effectively superseded by a draft in April 2004, although the draft ahs been stalled pending the revision of the Article 82 Guidelines, I think, by the EC Commission – as I understand the position.

THE PRESIDENT: Just before we go to the new draft, can you just help me on the old draft? Reading 2.16 and the definition, both of which refer to a hypothetical efficient undertaking, etc., does that imply that you look, in this case, at something that one could conveniently called the Ashgrove Water Co. Ltd., and work out how much it would cost that company to run this facility as a separate but existing operation, or do you look at what it would cost a hypothetical new company to establish that operation from scratch?

MR. THOMPSON: Well, I think if you put it like that, we would say the former ----

THE PRESIDENT: Because it does not leap from the page that you are looking at an entirely new greenfield build from scratch in carrying out this exercise.

MR. THOMPSON: Indeed, sir. I was going to put it in a slightly different way: it is clearly that one is expected to put forward a hypothesis, but as I understand it, the Authority and Dwr Cymru say that the only hypothesis you are allowed is that this is a company which, as it were, appears naked and therefore must invest in a completely new pipeline, and must borrow money from the bank. In my submission, there is no reason to include those two features when, in fact, you are dealing with a regulated water utility which actually has assets in the very place where the analysis is to be carried out, and that the hypothesis could perfectly well include the fact that this is a regulated water utility which already has a

pipeline to the relevant plant. In my submission that is a much more realistic hypothesis than the one that Mr. Jones operates on in his second witness statement.

THE PRESIDENT: If we read 216 together with 217, it also refers to stand-alone cost, etc., etc. It might be read as simply implying that what you are trying to do is, as it were, break out the existing costs of business activity you happen to be supplying.

MR. THOMPSON: Yes. I think we would say that you are dealing with the regulated utility which already owns assets in the very place in question.

THE PRESIDENT: Yes. So, the new draft?

MR. THOMPSON: The new draft. The relevant passages are somewhat shorter, and you find them at pp.6 and 36. At p.6 there is now a footnote ----

THE PRESIDENT: That has gone down into a footnote.

MR. THOMPSON: Yes – footnote 16:

> "In some circumstances the stand-alone cost of the line of business may also be relevant. The stand-alone costs of a line of business include those costs that will be incurred if the company undertook only the line of business in question. Where an activity generates revenues, the system may significantly exceed its stand-alone cost, including the cost of capital. This would be good evidence of excessive profits being earned on that activity".

Then, on p.36 there is a definition which I think is the same as the definition in the earlier version. It is certainly similar. We say that, if anything, the footnote, where it talks about 'the undertaking', it appears to be somewhat less hypothetical than the earlier version.

THE PRESIDENT: Yes.

PROFESSOR PICKERING: Could I just make one point? In the new definition, in 414A, the words 'joint costs' are added as well as 'common costs' which was what was in 414.

MR. THOMPSON: I am sorry, sir.

PROFESSOR PICKERING: In the definition in 414A on p.36, I am just pointing out that it is not quite an identical definition because 414A on p.36 introduces the term 'joint costs' which I do not think is in 414 on p.50.

MR. THOMPSON: Yes, that is right. There is a definition of 'joint costs' on p.35 in addition to the definition of 'common costs' on p.33. I am grateful.

PROFESSOR PICKERING: What joint costs would there be of a hypothetical operator only operating this particular service?

MR. THOMPSON: I must confess, I had not thought about this. The only issue that I can see that might fall within the scope of this would be the fact that Corus and Shotton are both

being supplied by the same system. But, quite where that cuts, and whether that is an answer to the question, I am not sure.

THE PRESIDENT: I do not know – you could produce a bit of sludge or something, but I do not know whether that is in any sense a product.

MR. THOMPSON: We are somewhat puzzled.

PROFESSOR PICKERING: That is why I asked the question. I am somewhat puzzled.

THE PRESIDENT: It may not be relevant here, but we note that they have changed the definition. Come back on the point if you ----

MR. THOMPSON: -- if inspiration strikes me.

PROFESSOR PICKERING: Can I just make one other point on this, which is that the definition does not appear to imply – and I wonder whether you would agree or disagree with me – that the stand-alone cost to be estimated does not indicate that it is a new entrant at that point. The implication is presumably more that the hypothetical supplier has already achieved its learning effects and become established in the industry. The only difference is that it does not have the economies of scope that a larger supplier operating through a number of facilities would have. Am I right in that?

MR. THOMPSON: I think that is, as it were, what I have put in terms of the hypothesis – that there is nothing saying that the hypothesis must be that the entrant is in a particularly weak position, for whatever reason – either to raise capital or in terms of what it would cost to create this asset. In my submission it would be unrealistic to make those assumptions.

In relation to Mr. Vajda's submission that this is a question of law, in my submission that is not right. The meaning of stand-alone costs in an OFT guideline, it is simply a question of what it means. There is no legal issue here beyond the meaning of the words and what the OFT may, or may not, have had in mind. In any event, the relevant question is actually what the Tribunal had in mind when it asked for a cross-check on the prices that were achieved by a top-down analysis. In my submission, the fact that the OFT may, or may not, have meant something or the other in relation to stand-alone costs does not really cast much light on that question.

THE PRESIDENT: May I ask it of you, sir, that it can be dealt with when Dwr Cymru comes along, or the Director. Is it clear that in this paragraph, which is about measuring supra-normal profits, that the OFT was directing itself to the kind of situation that we have got here – by which I mean that the facility of common carriage pre-supposes that there is already an existing network which you are going to use, and the statutory framework of the 2003 Act similarly pre-supposes that the network is already there. So, would it necessarily

follow, whatever 'stand-alone costs' mean in this context, that you would apply the cost of establishing a completely new facility to calculate the price of using a facility which, by hypothesis ---- or, **ex hypothesi** is already there?

MR. THOMPSON: I suspect that is more of a question for the Authority than for me, given the way they have put their case.

THE PRESIDENT: I am articulating it so that it can be thought about.

MR. THOMPSON: Indeed. As I understand the drift of that question, I think I probably adopt it rather than need to answer it.

In my submission, there are two questions of law in this area. They amount to very much the same thing because they both relate to undue discrimination. First of all, under Section 1 of the Water Act and the duties of the Director, and relatedly Condition E of Dwr Cymru's license; secondly, undue discrimination for the purposes of the Chapter II prohibition, both of which require that any cross-check must be on a like-for-like basis. In that respect, in my submission, it is very significant that at pp.26 to 27 of Day 3, Mr. Jones admitted that a greenfield MEA and a commercial rate of return would not be a like-for-like comparison for other customers of Dwr Cymru. In my submission, for that issue of law, which is indeed an issue of law, the analysis conducted in the second witness statement of Mr. Jones, and at considerable length in the Authority's skeleton argument, is essentially irrelevant for the issues which are before the Tribunal.

Turning to the substance of the issue, we say that the replacement cost must be the actual not the hypothetical ----

THE PRESIDENT: This is assuming you do it at all.

MR. THOMPSON: Yes. It must be based on the actual circumstances of the comparator – here Dwr Cymru – albeit on a stand-alone basis. But we say that you do not, for that purpose, ignore the fact that Dwr Cymru has been endowed with a pipeline from precisely Point A to Point B with which we are concerned in this case. By way of a broad analogy, if one was looking at the MEA of a water mill, we would say that the stand-alone costs of a water mill would be different depending on whether the mill was, or was not, located on a river. It does not appear to us that we are obliged to ignore the fact that the water mill is on a river already, and have to hypothesise that one might have to, as it were, dig a trench to the water mill. That is effectively what we are being asked to do here.

In relation to rate of return, we equally say that you should not ignore the fact that Dwr Cymru is a major regulated water company with a regulated rate of return, and which benefits from regulatory guarantees across its whole business, as Dr. Bryan pointed out at

pp.54 to 59 on Day 1, and Dr. Marshall pointed out at pp.42 to 43 of Day 4 – points that were not challenged in evidence. We therefore say that whatever points of detail may be made, that Dr. Bryan's approach is correct in principle, and that no other calculation has really been attempted by either Dwr Cymru or the Authority. On a point of detail, we note that in fact the rate of return used by Dr. Bryan in his analysis is actually slightly higher than the correct figure which one finds from Dwr Cymru's letter of 2 June, 2006

THE PRESIDENT: Can I just remind myself what Dr. Bryan's approach was?

MR. THOMPSON: It is in Annexe A again.

THE PRESIDENT: Annexe B is Capital Value Assessment. Annexe D is stand-alone.

MR. THOMPSON: It is apparently p.49, A212, where you will see figures of between 0.7 and 0.8 per cent. based on the figures then available. Some more figures were made available, I think, on 2nd June by Dŵr Cymru. It is a letter from Wilmer Hale to Mr. Dhanowa.

THE PRESIDENT: Yes, that was in reply to our question.

MR. THOMPSON: Yes, I think it is a four page fax. On p.4 of the fax you will see rates of return for water which will vary, in fact, from a negative figure minus 0.3 to a maximum figure of 0.7. So in fact the rates of return were actually rather lower than Dr. Bryan had assumed.

THE PRESIDENT: Dr. Bryan has done it on the MEA of the whole business, presumably?

MR. THOMPSON: Yes, he has done it on the figure at the bottom, the whole business.

THE PRESIDENT: We do not have an RCV for water, apparently?

MR. THOMPSON: I do not think we have one.

THE PRESIDENT: Well there is not one on the table. Yes?

MR. THOMPSON: Dr. Bryan thinks there is only a single figure for RCV.

THE PRESIDENT: It looks like it.

MR. THOMPSON: The next topic was retailing.

THE PRESIDENT: Do you want to take a short break at that point, Mr. Thompson. That might be a convenient moment.

MR. THOMPSON: Yes.

MR. ANDERSON: Sir, I wonder if I could beg the indulgence of the Tribunal and ask for 10 minutes just because ----

THE PRESIDENT: Of course, Mr. Anderson.

MR. ANDERSON: -- I have another matter that I promised I would deal with by telephone before noon.

THE PRESIDENT: We would be delighted, 12 o'clock then, shall we say?

MR. ANDERSON: I am very grateful to you, Sir.

THE PRESIDENT: Thank you.

(Short break)

THE PRESIDENT: Yes, Mr. Thompson?

MR. THOMPSON: In relation to retailing we say that the analysis in the interim Judgment of particularly paras. 405 and 413, has been shown by the additional evidence to be essentially correct and that the picture is now clearer and we refer, in particular to pages 23-26 of day 2 and the evidence of Dr. Bryan as to what Albion is actually doing and also our pleaded case at paras. 30 to 42 of the reply where we draw the elements together. Dŵr Cymru has now added a further element by reference to the meaning of 'regulated services' and the Tribunal will, I think, have received a letter also dated 2nd June ----

THE PRESIDENT: Yes.

MR. THOMPSON: -- some 24 pages, although it has '19' in manuscript on the front, I do not know what has been missed out but if one turns through the fax through p.18 is how it is numbered – p.18/24 – and you will see that there is a list of appointed activities, which include a number of fairly obvious candidates but also conservation. You will see "Conservation" about the seventh item, whereas non-appointed activities, the third one is consultancy and you will recall Dr. Bryan's evidence on that, that where, for example, he has advised on disposal of paper sludge he would regard that as something separate and a form of consultancy, but he would regard the advice he gives to Shotton Paper as a very large customer, particularly in relation to water usage, to fall within the category of conservation and that he regards those activities as falling within the scope of regulated activities in the particular context of a very large user, and we would submit that such a user is in a special position and entitled to specific services. In that respect there is a document that we looked at during my opening, I think, which I think it is worth going back to, which is the draft guidance which Mr. Hope accepted was in circulation at the time of the Decision, which you find in the witness evidence bundle for Dr. Bryan and Mr. Jeffery, tab 10, p.26-28. You will recall it is a "Methodology for Wholesale Prices".

THE PRESIDENT: Yes.

MR. THOMPSON: We looked at the primary retail activities and secondary activities on p.27.

THE PRESIDENT: Just remind us what this document is?

MR. THOMPSON: Yes, it starts at p.20 and it is called "Development of a Revised Access Code. Draft Guidance on Access Pricing". Mr. Hope said that he had seen it before, and that I think he had been involved with it. I can find the reference to that in his evidence, but it

was in circulation, as we understand it, at about the same time as the decision. You will see at the bottom of p.27,

> "Activities which may be reduced or avoided altogether as a result of a customer switching to a licensee are: recovery of bad debt, because the licensee will now be responsible for collecting revenues from the customer. The extent to which this is reduced will depend on the extent to which the entrant retailer represents less of a risk of non-payment than the customer ----"

Then, over the page, water conservation advice: "Although undertakers have a statutory duty to promote the efficient use of water to customers, this activity will also become the responsibility of the licensee for its customer". Then it goes on,

> "Retail costs are related to the number of customers rather that volumes of water supplied. It would be wrong therefore to apportion retail costs on the basis of customers' consumption. That said, we can expect the retail costs for customers using 50ml or more to be greater than the average for all customers because ----"

And then there is a series of lists. In particular,

> "(q) water conservation advice would be customer-specific; (r) bad debt costs would be higher because bills are higher, but this may be offset by the ability to disconnect most non-household customers; (s) account managers are often assigned to large customers.

So, in my submission, this analysis – internal Authority analysis – is really quite consistent with Dr. Bryan's specific evidence, given that this is in fact one of the largest customers that Dwr Cymru has. In my submission, against this evidence, the really rather rhetorical criticisms which are contained in Dwr Cymru's and the Authority's submissions, in my submission, look somewhat ridiculous because all this stuff about the officious postman is really quite inconsistent, and infinitely regresses of people doing nothing is really nothing to the point in relation to either Albion's activities or the recognised activities which the Authority had in mind at precisely the time when it took this decision. Equally, the decision looks pretty foolish in that it was only concerned with water flowing through pipes, you will recall, and forgot all about the question of what was involved in retail services to a major customer, despite the fact that the Authority itself had recognised that such services existed in guidance drafted at precisely the same time as the Decision. So, in my submission, this is another serious defect in the Decision, which means it cannot possibly be upheld.

Turning to the issue of resources ----

THE PRESIDENT: Are you going to say anything about the 5p retail margin?

MR. THOMPSON: I do not think that is a matter for me. I think that is a matter of the evidence that has been put forward, and for the Tribunal. That is our evidence. It is obviously under challenge, and I do not think there is probably anything very useful I could do by saying, "Oh, yes, it is", and them saying, "Oh, no, it isn't".

THE PRESIDENT: Yes.

MR. THOMPSON: In relation to resources, we say that it is common ground that, now, one should look ---- This is for the purposes of ECPR, assuming that an ECPR analysis is to be followed. We say it is common ground that one should look at the actual avoided costs for the purposes of ECPR. But, we say that is not necessarily equal to the relatively low costs of United Utilities' current supply for the reason that, as we understand it, the intention was that that supply was intended to be continued to Dwr Cymru. That is a matter that is addressed at paras. 23 to 25 of Mr. Jeffery's second statement. In those circumstances we submit that the conclusion provisionally reached by the Tribunal that the regional average should be used as a proxy for the saving is in fact correct – but by a different route, namely that that is the best available estimate of what would be saved if this very large amount of water did not have to be achieved somewhere in the Dwr Cymru system.

THE PRESIDENT: Physically speaking how would that work? Is there another pipe that takes it from Ashgrove to Bretton, or somewhere, or what? How would it work?

MR. THOMPSON: Well, Mr. President, I think it is a question between two large undertakers as to how they would allocate the supplies of water between themselves. I do not think it is a matter that Albion can possibly ----

THE PRESIDENT: Because United Utilities is also taking water from ----

MR. THOMPSON: Indeed. So, there could be a net.

THE PRESIDENT: -- that source for its own use, yes.

MR. THOMPSON: The position that Dwr Cymru seems to adopt now, by contrast appears at para. 91 of Mr. Jones' third statement. It is a point I mentioned in opening. But, he makes the point, at p.19 of his third statement, in the last two sentences ----- He has referred to the cost of 3p per meter cubed, reflecting contribution to fixed costs.

> "However, the fixed cost element of Dwr Cymru's costs contribution would not automatically fall with the reduction in volume, but would require renegotiation. The only cost which would be avoided without renegotiation would be the element for power costs which, in 2000/2001, was 0.7p per meter cubed".

As I understand it, he is saying that on the ECPR logic, Dwr Cymru would be entitled to charge its retail price, discounted only by 0.7p notwithstanding the fact that Albion was replacing it both in relation to resources and in relation to retail supply at the other end. In my submission, that is a yet more spectacular instance of a margin squeeze occasioned by ECPR, if it were right, which would be blatantly in breach of the Chapter II prohibition.

The only other point I was going to touch on was the question of the remedy ----

THE PRESIDENT: Before we come to the remedy, Mr. Thompson, how do you deal with the argument advanced by Dwr Cymru that if you are right, the effect of all this is actually to have repercussions for other customers – in particular, domestic customers – as a result of the way the system works?

MR. THOMPSON: You may recall – and I have not got the reference at my fingertips – but Dr. Marshall, as an experienced regulator, said that she was somewhat puzzled by this pre-occupation with a small increase in price for a large number of people as against a large reduction in price for an individual who may have been subject to massive overcharging for many years with substantial adverse effects not only to their commercial, but also their personal lives as they seek to remedy the situation. You may also recall that at the end of last year's hearing, we saw that I think £9 had been given to each of Dwr Cymru's customers and that Albion had generally received £18 in relation to its potable as well as non-potable. But, on our case, Albion has been overcharged by some £1 million for five or six years. It seems to us that we should concentrate on the beam rather than the moat in deciding where the justice of this matter lies if the Tribunal is persuaded that that is in fact the just position.

Looking at the reality of it, our understanding is that Dwr Cymru is an extremely profitable company with large and substantial reserves, and we do not think it is, by any means, a foregone conclusion that if it were found to have abused its dominant position by overcharging to this sort of level, that it would automatically be either entitled, or that it would be correct to take into account the possibility, that it might then serve to recover these sums from the domestic user. That seems to us to be a causal link which has not yet been made out, and which, as a matter of policy, should not necessarily be accepted. It is certainly not normally taken into account when deciding whether or not to, for example, levy a fine on an abusive company, where the effect of the fine may mean that somebody else, somewhere else, has to pay more for the product in question.

THE PRESIDENT: It is the knock-on effect. Taking a wider view of this case, the argument is the potential knock-on effect of other customers having to pay more if particular customers pay less.

MR. THOMPSON: Yes. But, I think our basic position is that if the structure of charges has to be restructured on behalf of ten customers, the fact that there may be an effect in relation to a very large number of customers it is inevitably going to be substantially mitigated.

THE PRESIDENT: Yes, I think that was more or less what Dr. Marshall said, I think.

MR. THOMPSON: Yes. I think at its height, supposing this were replicated across the whole of the non-potable system – which is obviously not the case for some of the customers who are already charged at very low rates – then it might lead to some overall increase across the Dwr Cymru business, but we would not necessarily accept that it would be at an impossibly large level, and that would have to be taken into account both by Dwr Cymru internally, and in relation to any further review, given whatever policy issues had been indicated by the Judgment in this case.

Just briefly turning to the issue of remedy – which is obviously not binding out hands, looking forward, because it obviously depends very much what the outcome of the case ultimately is – it does appear to us that there is a potentially quite elegant twofold remedy: first of all, in relation to margin squeeze, that some form of margin (and we would say 5p per meter cubed) should be allowed between any Dwr Cymru offer price to Shotton Paper and the price offered to Albion (obviously, the number is a matter for ----

THE PRESIDENT: Sorry? That is between which price and which price?

MR. THOMPSON: That Dwr Cymru would not be permitted to offer an integrated retail service to Shotton Paper without at least a margin for the purposes of the retail. Obviously, an analogous issue in relation to resources that one would specify some form of minimum margin in relation to both retail and resources.

THE PRESIDENT: Are you in a position to translate that into arithmetic for us? The present retail price is around 26 from memory.

MR. THOMPSON: Yes. There is a point made by Mr. Jones that the retail price, as it were, is subject to renegotiation, but it is somewhat out of date. So, effectively it would be a margin between the offer price to Shotton Paper and the offer price to Albion.

THE PRESIDENT: So, for illustrative purposes, if we took it at 26, what access price does that approach give you?

MR. THOMPSON: Well, I think it would be an 8p margin, if one took 3p for the resource and 5p for the retail.

THE PRESIDENT: Yes.

MR. THOMPSON: In relation to excessive pricing, the issue of treatment is a matter for the Tribunal, but you have the figures that Dr. Bryan has put forward. The more important question is the question of distribution, and one possible remedy which, in my submission, would achieve the substance of what is required – that Dwr Cymru could not price its non-potable distribution costs higher than the regional average costs of raw water distribution. That would appear to us to address the substance of the matter, and to be fair as between the non-potable customers and the generality of Dwr Cymru's customers who all receive raw water distribution charged at that sort of level. So, in our submission, that would be a way of addressing the excessive pricing issue on the substantial question of distribution.

THE PRESIDENT: Those two approaches – just a quick look would give rather different results, would they not?

MR. THOMPSON: Well, they would be addressing different questions.

THE PRESIDENT: Yes, I agree, but the pure margin squeeze point, just taking it by itself, would give you 26 minus 8; is that right?

MR. THOMPSON: Well, it would give you minus 8.

THE PRESIDENT: Minus 8 off what?

MR. THOMPSON: Exactly.

THE PRESIDENT: But on the hypothesis of 26, it would give you 18.

MR. THOMPSON: Yes.

THE PRESIDENT: Which is quite close to the 19 that was on the average accounting cost basis in the Decision.

MR. THOMPSON: But that is because it is addressing a quite different question which is whether or not Albion, as a retailer, effectively – or as a common carriage customer – has enough margin to be able to compete.

THE PRESIDENT: I see. So, this margin is on the basis of a hypothetical retail price. It is by hypothesis a fair price in the first place.

MR. THOMPSON: Yes. So, it simply addresses the margin. I am sure that the President at least has it in mind, but it may be worth turning up the remedy in the *Genzyme* case, which is in the supplementary authorities ----

THE PRESIDENT: Just before we do that, what access price would the second one give you – the excessive price … non-potable no higher than the regional average cost of raw water plus an allowance for treatment would give you something of the order of four; is that right?

MR. THOMPSON: Something of that order, yes. It obviously would not have the protection of the margin. So, in principle, if raw water distribution costs turned out to be quite different, then, in principle, the price would go up. But, on the facts as they appear, it would, at least in the short term, lead to a quite substantial reduction in price. But, that reflects the reality of the situation. If you looked at it from Albion's interests, there has been some discussion – quite a lot of discussion – in the Authority's skeleton about Albion's brokerage activities, which it seems to regard in some respects as disreputable. But, in effect, the excessive pricing remedy would be a form of brokerage remedy in that it would be a reduction which would feed through presumably to Shotton Paper, and Albion might be remunerated by reference to the reduced price, whereas the margin would be a margin for Albion as a retailer and resources supplier. So, they are quite distinct issues. But, in our submission, that would be a reasonable shape for a remedy which would reflect both the forms of abuse alleged by Albion.

THE PRESIDENT: Yes.

MR. THOMPSON: I say this last thing somewhat tentatively, but it relates right back to the first point that I addressed in relation to dominance: this is a case which has been bedevilled by delay, going right back a very long time. There are obviously difficult issues at stake which take time to deal with. But, as I think Dr. Marshall has said, the issue of delay does in fact constitute a barrier to entry for new entrants – not only for Albion, but for the market generally. I am sure it is a point that Mr. O'Reilly has in mind. So, we do, by way of final plea, as it were, seek some form of finality in this case in relation to its forward future conduct.

Those are the points I had.

THE PRESIDENT: Thank you very much, Mr. Thompson.

MR. O'REILLY: Perhaps I could start off by rehearsing how we came to be involved in these proceedings. Our intervention arose because the Regulator sought, in the Decision which was appealed, to use Section 66(e) as a cross-check, and equated it to ECPR. Because of our business, we felt that that matter had to be investigated further. We were actually the first party to appeal this decision, although our appeal is stayed. Reference is made to that in para. 85 of the interim Judgment. If one has a look at the Decision which is being appealed, the references to the cost principle begin, or there is a significant section which begins at para.317 and goes to para.331. There is also para.338 which I would invite the Tribunal to re-read to see just how significantly the Authority's view about the cost principle is woven into the fabric of the Decision.

THE PRESIDENT: Just a moment.

(The Tribunal confer)

THE PRESIDENT: Yes?

MR. O'REILLY: We see immediately before para.317 a cross-heading "Efficient Component Pricing Rule", "The Cost Principle", and "The Second Bulk Supply Agreement." At para.318 the Authority states: "We therefore think that there are dangers in accepting only one approach when assessing costs", and then the final sentence of that paragraph it says: "In this particular case we have had regard to both the price of the second bulk supply agreement and the access price which we think the cost principle would generate." In 319: "We have also considered ECPR" and there are two further references to costs' principle in that paragraph.

The Decision goes on, at para.323, the Authority indicates that it may have some concerns about using ECPR because it may be perceived as being more favourable to undertakers. What it says: "Access prices calculated under ECPR may be perceived as being more favourable to undertakers than prices arrived from other approaches." This is a concern they have but, in my submission their fears are allayed by the fact that in their view Parliament has passed a statute which seems to vindicate that view and support it. They express that in para.324. "The cost principle under the Water Act 2003 is also a type of retail minus approach to access pricing." It talks about how it came into force and, on the next page (p.83) they set out the text of the section in full. There is a couple of dotted out references there, those are references to the immediately preceding section, but apart from that the text of the section is set out in detail. They use that, in my submission, as a philosophical justification, or at least a prop and cross-check to their view that the way to calculate the price is by using the price of 25.8p and subtracting 3.3p which they say is the input water price. In our submission this really goes to the fundamental question about whether the Decision should stand or not. Therefore, in our submission it is right and proper that the Tribunal deals not only with the question of ECPR but also with the question of s.66(e).

It is our submission that the only way the Tribunal can deal with that is to analyse what s.66(e) says. We will hear some submissions a bit later no doubt, about the interpretation of that section and those will focus on subsection 3 which, if we turn back to p.83, we will see has an (a) and a (b). (a) is "… reasonably expected to recover from relevant customers", and that is being interpreted as the retail price, and (b) is ".. unable to recover from those customers as a result of their premises being supplied with water by the licensed water

supplier." So both of those are said to be the retail price and, in subsection 4 we have the arrow costs and that is what is said to be the avoidable costs and the conjunction of those two is said to give us a retail minus.

THE PRESIDENT: Just give me a moment just to re-read the section, because it works in a fairly convoluted way, does it not? (After a pause) "… the expenses reasonably incurred …" and then "… the appropriate amount in respect of qualifying expenses and the reasonable return on that amount." ".. to the extent those sums exceed any financial benefits …" etc. Then "… the qualifying expenses … reasonably incurred." "… the appropriate amount which he reasonably recovered from relevant customers …". Relevant customers is in subsection 5. Yes, I think we remember roughly now.

MR. O'REILLY: So subsection 3 will be said to be the retail price and these are the sums that the incumbent would have received from those customers were not the competitor to have taken over the supply. Subsection 4 is the arrow subsection and these are said to be the retail costs. It is our submission that that is an inadmissible reading of this section, because it ignores subsections 1 and 2.

We have made submissions last year about the meaning of this section, but perhaps I can just go over those at the end of my closing. Before I get there can I just make one or two other points? Mr. Thompson has already addressed the question of the officious postman. We say it is also a ridiculous analogy to draw. In any event, looking forward and, in my submission it is worthwhile looking forward as well as looking backwards, s.66(a)(b) and (c) set out types of competition which the Government has promoted, Parliament has given legislative force to, and any suggestion that these modes of competition are not legitimate cannot stand. In any event, the types of arrangement that are being proposed are exactly the same, in my submission, as what happened in other utilities industries such as gas and electricity. Those utilities and their customers have benefited, in my submission, greatly by the introduction of competition.

The next point we wish to make is on the relationship between the Competition Act 1998 and the Water Act 2003. There was a suggestion at one stage that the Competition Act did not operate in relation to this Statute. I am not sure that that is being pursued any longer. In the interim decision at para.127 you have made a reference to this and it says: "Nothing in s.66(d) or elsewhere in the Water Act does preclude the Office of Fair Trading or the Director from enforcing the Chapter II prohibition under s.18 …." and so on. It is our submission that the Chapter II prohibition applies and, indeed, in interpreting s.66(e) regard should be had to the Chapter II prohibition in the sense that Parliament, if it had wished to

override that, would have said so; and secondly, in interpreting s.66(e) one has to have regard to the idea that Parliament would have intended it to be consistent with it.

In relation to ECPR, we support everything that has been said by Albion. We really have very little further to add to what has been said by them. The ECPR principle seems to us to focus on a different principle altogether, namely, restricting entry to those who might in some sense be said to be inefficient according to the definition which we say does not correspond to the way that that would normally be used, whereas the Chapter II prohibition and EU competition law is directed at a different goal, namely supporting the competitive process. In terms of the details we propose not to make any submissions other than have been made by Albion, save to support specifically the four box diagram handed in and this, in our submission makes it clear that the Chapter II prohibition and the ECPR test are significantly different. The ECPR price deals with only one box of the four, whereas ----

THE PRESIDENT: Can I just glance back at the four box diagram, if I have it to hand? (After a pause) Yes.

MR. O'REILLY: As we see we have an "up" and "down" and a "fixed" and "avoidable", such co-ordinates, the ECPR deals with only the bottom right hand box, that is to say the downstream avoidable costs, whereas competition law in the European Union is directed at all four of those boxes, therefore it cannot be said that it is the same test, and I am not sure that anyone still says that it is – indeed, it can be incompatible, as Professor Armstrong indicated yesterday. In our submission the ECPR test will tend to give a tighter margin than would be allowed by the margin squeeze test in many cases.

A point was made yesterday that all costs on the downstream market will be avoidable in the long run, but the question is what period should be used? Clearly, if a competitor is to take a water supply for a one year period, then that should be the period used in our submission and therefore to say that over a period of 20 years all of those costs might be avoided is nothing to the point unless the margin being given is on that 20 year basis. Clearly, the way the decision works it is that the margin being given was the immediate costs avoided rather than the long term costs avoided.

THE PRESIDENT: So let me see if I follow that. If you have a 20 year agreement, or a 10 year agreement, which might well be realistic for a large customer, you say you work out the avoided costs over that 10 year period?

MR. O'REILLY: It might be worked out on a year by year basis so the margin might increase over time.

THE PRESIDENT: I see, so it steps up as you go through?

MR. O'REILLY: Yes, that would be the only sensible way of doing it. That, I hasten to add, is the submission of those on the other side that these costs are avoidable in the long term. We say that one should take the long term avoidable costs immediately.

THE PRESIDENT: Yes.

MR. O'REILLY: In developing the cost principle, we have heard what Albion has to say about Mr. Hope's evidence and we would support and adopt those points. I would like specifically to deal with his history of the cost principle itself, in other words, the looking forward principle, rather than the looking back on to ECPR. Mr. Hope confirmed that he was involved in formulating the view of Ofwat as to what the principle meant and he gave that evidence on day 2 at p.59, lines 16-17 and that at a high level he was involved in drafting the sections of the Decision relating to ECPR, and that he saw a late draft and was happy with it. He gave that evidence at day 2, p.57, lines 13-16. His evidence indicated the way that Ofwat came to the view that s.66(e) was an ECPR or similar principle. In my submission that evidence was very telling in that it indicated that Ofwat had not done a proper analysis of s.66(e). It relied on what it thought it believed DEFRA had said in the consultation paper. We looked at para.28 of Mr. Hope's statement and in that consultation paper we read the words which were apparently relied on, but in my submission they meant a cost principle, and I do not know whether it is worth turning that up again -----

THE PRESIDENT: The consultation paper?

MR. O'REILLY: The consultation paper.

THE PRESIDENT: I do not recall ECPR being discussed in the consultation paper.

MR. O'REILLY: No, precisely.

THE PRESIDENT: Where do I find the consultation paper now?

MR. O'REILLY: I was just referring to Mr. Hope's statement at para.28, where he gives an extract, but we can go to the full document, if you like?

THE PRESIDENT: (After a pause) Yes.

MR. O'REILLY: Paragraph 28 of Mr. Hope's witness statement.

THE PRESIDENT: Yes.

MR. O'REILLY: So the extract from p.43: "The Government believes that whatever methodology or methodologies are chosen the access charges should be consistent with three general principles." The first of these is:

> "Undertakers' prices for distribution and wholesale supply should not in themselves deter potential licensees from seeking to supply customers. This

implies that they should reflect the actual costs of providing the service. They should not be unduly discriminatory and they should be transparent."

The words: "They should reflect the actual cost of providing the service" are not in my submission consistent with an ECPR principle. When that was put to Mr. Hope he immediately said "Well look at the second bullet point", and here we are talking about stranded assets. You will recall that there was some discussion with Mr. Hope about how this would work in terms of an ECPR principle, and in my submission he was unable to give a satisfactory answer to that. It neither works when there is zero per cent. stranding, nor when there is 100 per cent. stranding, and he was unable to explain what happens on an intermediate position.

THE PRESIDENT: So you say, for example, in that first bullet point the words 'the actual costs of providing the service' cannot be construed – I know it is not a statute – cannot be given the meaning of the avoidable cost of not providing the service?

MR. O'REILLY: No. These say that it should reflect the actual cost of providing the service. In my submission that principle gets transferred across to s.66(e) which is headed, of course, "The Costs' Principle".

THE PRESIDENT: Yes.

MR. O'REILLY: If the Tribunal needs a steer about what s.66(e) means, one should take it from that provision in the consultation document. Upon asking Mr. Hope about whether or not legal advice had been taken he indicated that there had been some internal legal advice and that is at day 2, p.59, lines 18-20. In our submission that was not sufficient, given the central and critical importance of this question to the whole enterprise. Subsequently guidance was published and a series of drafts were produced and the guidance was finally published in June 2005, shortly after the hearing last year. I asked Mr. Hope about some of the illustrative examples which gave a 0.1 per cent. margin. Mr. Hope said that he thought there were some other examples which were more beneficial to entrants. He was not re-examined about that and we have not managed to find those.

THE PRESIDENT: Have we got that guidance handy? Where do I now find it, Mr. O'Reilly? I just want to glance at it while we are on it.

MR. O'REILLY: I am informed it is also at tab 15.

THE PRESIDENT: Can you just take us to where we find these various examples?

MR. O'REILLY: Yes. At p.63 in Appendix 2. It is headed 'Detailed Methodology for Calculating Case Specific Access Prices'. The first example starts at the middle of p.63. You will see there the equation at 6.5.1 in the centre of that page – Access price equal to

any expenses reasonably incurred plus the retail charge minus the ARROW costs. Then, each of those components is worked out separately. So, first of all, retail charge, ARROW costs, and the is a table of ARROW costs at the top of p.65. Then, expenses incurred at p.66, and table of expenses incurred at p.67. Then, calculations at the bottom of p.67, giving the final figure – the bottom table - at p.68 . The total discount is in the penultimate column, two lines up – 397. That is the total margin that is being offered for the retail charge of almost £350,000.

Then there is an example for combined supply prices at p.68 at the bottom, and worked through. Perhaps just to make sure that we have got everything, there is a calculation at p.73 which, for a retail income of £381,000, gives a total discount of £20,000. But this includes common carriage and so on. I have not actually worked through this table. If you wish me to address you on this ----

THE PRESIDENT: I am just getting a feel for what these examples show at the moment.

MR. O'REILLY: On p.75 there is a table for avoiding negative access prices. Sir, the table on p.68 gives you ---- This is for the retail example, sir. So, at p.68 this would be the computation for the form of competition set out in Section 66(a).

THE PRESIDENT: Yes. So, out of that margin the new entrant has to provide the water.

MR. O'REILLY: No. That includes the price of the water.

THE PRESIDENT: Right. Okay.

MR. O'REILLY: But, on that £397 the new entrant has to run his entire business. One can easily do the calculations. If one had one hundred customers, then clearly you would add two noughts on to the end of there. But, you would not be able to engage many staff – one, probably, is the answer, for one hundred customers.

When Mr. Hope was on the witness stand, Professor Pickering asked – and we adopt this question: "Do you not think that there is very considerable responsibility on a regulator – almost acting as the price leader?" We say, "Yes, there is". There is a responsibility upon a regulator to ensure that if they are going to give figures to the market, they give realistic figures. We submit that these are in fact realistic for what OFWAT had in mind, and that they were presiding over a competition regime which they did not expect to flourish. The water companies got the message very clearly because I asked him, on Day 2 at p.61, whether he was aware that some companies published indicative prices that gave a zero margin. He said, yes, he was aware of that. I asked him whether or not that was appropriate, and he said, "Yes". His answer was, "We did not consider the companies' indicative access prices to be unreasonable".

In my submission, this is not what a regulator should be about. Can I ask whether we could perhaps a look at the final determination document that was shown to us yesterday? At Section 3 there is a chapter at p.43 which is entitled 'The Longer Term Context Beyond 2010'. There are a number of items, but at p.45 at the bottom we have reference to competition in the water industry . Remembering the timescale being discussed here is beyond 2010.

> "As a result of the Water Act 2003 a new market competition regime for the largest business customers using 50 megalitres a year or water or more is likely to come into force in 2005. This will not affect other business customers at least until after a review due in2008."

That is the three year review which was mentioned in the parliamentary debates.

> "The government wants to see how price competition evolves before considering extending it to smaller business customers. It is difficult to predict, but we expect price competition to be more of an issue at the price review in 2009".

So, in my submission, what is happening here is that the competition that is being introduced has been relegated almost to a footnote. There is one other reference I found to competition. No doubt there may be some others, but the one I found is at p.242. This is in Chapter 16, dealing with uncertainties. The chapter starts at p.240. A number of uncertainties are set out on pp.240 and 241 which are addressed by OFWAT in setting their price determinations, but it is the paragraph at p.242, immediately before Section 16.2 which I would like to have a look at. It reads:

> "It is natural that companies should seek protection from as many changes as possible. However, we have concluded that some of the changes they propose are adequately dealt with in the price setting mechanism – for example, power costs and pensions. Others will be reflected in changes in the retail price index. Others are simply business risks that need to be accepted by water and sewerage companies as for any other company – for example, loss of customers through competition".

Now, if they stopped there that might have suggested that this was a real concern, but they then say,

> "We have reviewed all of the issues raised by the companies carefully and we judge that the risks are small, and even if they appeared, companies should use their management skills to minimise the effects".

So, in my submission, the risks of any competition being said to be small is being relegated to a footnote even in an analysis of the industry which they regulate for the period beyond 2010, and in my submission this shows disinterest, at most, in competition.

THE PRESIDENT: But, what it does say there, Mr. O'Reilly, in the last sentence is that in OFWAT's view, the play of competition introduced by the 2003 Act is not going to affect the cost of capital or the cost of capital has been built into the calculation.

MR. O'REILLY: Yes. But, in my submission, they still are ----

THE PRESIDENT: Do you say that that is all on an implicit assumption that it is not going to mean very much?

MR. O'REILLY: Yes, indeed.

(Adjourned for a short time)

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MR. THOMPSON: Just for the Tribunal's note, there were three references which I referred to which I did not have. First of all, Mr. Hope, the reference to the draft guidance we looked at (day 2, p.55, lines 11-23). In relation to Professor Armstrong and the pass-through issue, that is day 3, p.75, mainly lines 5-16, and the relationship between margin squeeze and ECPR and the fixed cost issue, that is debated on day 3, p.54-55, 61-63 and p.72, lines 5-29. I think there may be other references, but those are some of them.

THE PRESIDENT: Thank you.

MR. O'REILLY: Sir, just going back to one point we covered shortly before the adjournment, if I could ask you to turn up the Ofwat Access and Guidance Codes again?

THE PRESIDENT: Tab 15, was it?

MR. O'REILLY: Yes. We looked at the retail calculation. If I could ask you to look at a combined calculation. We had a look at the table at p.73 and the Tribunal will see there in the penultimate column a total discount for £20,397. The £20,000 is a discount on common carriage, but that presumes that the entrant will buy their own water.

THE PRESIDENT: That was the question that I was asking.

MR. O'REILLY: So that is right. If you want to see how this works in practice, as an appendix to Dr. Marshall's report she sets out some of the figures taken from the published figures given by the water companies. It may be worthwhile just turning that up.

THE PRESIDENT: Yes.

MR. O'REILLY: It is Dr. Marshall's first report, behind annex 3, which is a list of papers, is a document which, in my version is headed "Appendix B1" . On the first page we have various water resource zones for Anglian Water. Perhaps it is useful to turn to Dŵr Cymru

which is where we may be, it is the fourth page of that section. Sir, at the top of the page there should be Chester, which is Dee Valley, and then the next three ----

THE PRESIDENT: I am sorry.

MR. O'REILLY: I am turning to the fourth page in that section.

THE PRESIDENT: Yes, thank you.

MR. O'REILLY: Sir, at the top we have Chester, and then three areas which are in Dŵr Cymru's area, in fact, there is Pembrokeshire, the next one I am not going to attempt to pronounce that.

THE PRESIDENT: Well part of it is Anglesey, but I am not sure what the second ----

MR. O'REILLY: The third one is "all others", so it appears to be a compilation, as it were. If we assume that Shotton is in the third one – I do not think it makes any difference which one it is – if we imagine that it is taking 500 megalitres per day plus which it is, it is taking approximately 10 times that amount, we see the access margin is 3.86 per cent. and that is for 2005/06 and 2006/07, and that is the common carriage access price. That is the margin and that is the discount that you get for supplying the water, treating the water and when it comes out of the pipe at the other end, retailing the water. So we say that the price league given by Ofwat in its access guidance has been translated through by water companies into very slim margins indeed.

If we turn – the pages are not numbered, if I could indicate what I am turning to – six pages on in my version at least there is a landscape table headed "Appendix B1". This may be the way it is printed out. It says "Wholesale Discount", "Wholesale Scenario", "Common Carriage".

THE PRESIDENT: Yes, right at the beginning. Yes.

MR. O'REILLY: I do apologise, Sir, my file is not tabbed up.

THE PRESIDENT: That is all right, the document is not paged.

MR. O'REILLY: We see in the left hand column we have the undertakers – Anglian, Bournemouth and West Hampshire, Bristol, Cambridge, Dee Valley and Dŵr Cymru. On the left hand side of the table we have retail and on the right hand side of the table we have common carriage. For retail at 500 megalitres per year – 500,000 m^3 per year there is a wholesale discount of zero, and that translates out to – we have a retail price of 363,000, that is the purchase price and there is a zero margin. Over towards the right hand side, where we have the common carriage prices, there is the same quantity 500,000, we have the retail price the same, and we have a slight discount of 14,000 for common carriage, but again that pre-supposes exactly the same input, that is to say the new entrant would buy the

water, treat it, and then retail it when it came out at the other end of the pipe. So effectively what the undertaker is charging for simply allowing the new entrant to use the pipe is 349,000. In our submission, not only has OFWAT adopted ECPR which is, we say, conceptually wrong, but they have given a price lead which allows the water companies to believe that they can cut down the margin, pare it down to the finest margin imaginable, and that they will get away with it. That is precisely, in our submission, what is happening, and OFWAT has done nothing about it at all.

That is all I wanted to say about those calculations. In relation to parliamentary views which have been mentioned on more than one occasion, it would be our primary submission that what is discussed during the debates in Parliament is nothing to the point if the Section is reasonably clear in its own terms – I am talking about Section 66(e) which we say, following a bit of analysis it is. But, if we look at the parliamentary debates, we say that one thing is absolutely clear: that is that parliament intended that there be a review after three years, and the implication, we say, that can be drawn from that is that there should be at least three years of reasonably vigorous competition, sufficient to enable it to be pilot-tested. What will happen, if the types of figures that we have just seen are the type of figures that are imposed, is that there will be no competition and no opportunity for a review after three years.

I should perhaps say that some water companies are also charging for switching water, which I think there was a slight debate about between Professor Armstrong and Dr. Marshall as to whether or not that was permissible; whether it was possible for a water company to charge an additional figure on the basis that it was more expensive to supply a third party.

MR. ANDERSON: There is no suggestion that that arises in this case.

THE PRESIDENT: I had got the point, Mr. Anderson. Thank you.

MR. O'REILLY: In relation to the existing regime, we would like to make the point that although we need to look very specifically at the decision in relation to Shotton, the water competition regime is now in force and is, we say, not working well. Just so that the Tribunal has the most up-to-date references from all sources, we would just like to draw your attention to a DTI Treasury document which was published in May 2006, which is available on the various websites. It is called 'Concurrent Competition – Powers in Sectoral Regulation'.

THE PRESIDENT: What do you want us to infer from this document? It was published about a fortnight ago.

MR. O'REILLY: That is correct. I am simply drawing the Tribunal's and the other parties' attention to it.

THE PRESIDENT: What do you want us to look at in it, if anything?

MR. O'REILLY: The report discusses whether or not sectoral regulation is a sound approach and what relationship there should be between the Office of Fair Trading and the sectoral regulators. We suggest that the report is broadly in favour of sectoral regulation in the event that the sectoral regulators do their job well. One can see that, for example, in para. 7 where it says,

> "Indeed, sectoral regulation has played a key role in opening up markets and stimulating market development, removing barriers to entry, regulating dominant players and in ensuring fair, transparent pricing".

We say that that may not have happened in this industry.

Sir, I do not know whether you want me to go through Section 66(e) – whether it would help the Tribunal, particularly as Dwr Cymru have got a new team and they may not have -- --

THE PRESIDENT: I think, from our point of view, we are happy – unless there is any particular reason. We have got it all in writing, Mr. O'Reilly. We can remember the structure of the argument last time.

MR. O'REILLY: Thank you. Is there anything else I can help the Tribunal with? Otherwise, I am finished.

THE PRESIDENT: No. Thank you very much.

MR. ANDERSON: I have headed what I was about to say both 'Opening and Closing'. This is my first opportunity of addressing this Tribunal.

THE PRESIDENT: We did offer you an earlier opportunity.

MR. ANDERSON: I know. I know, but I was overtaken with the excitement of the evidence and I did not want to interrupt it! (Laughter) Can I start by making some observations about the scope of the appeal? We would submit that this appeal is not about setting an access price any more than it was for the Director to set an access price. The issue in this case – and particularly in the light of my learned friend Mr. O'Reilly's submissions it is important to remember – is whether the Director was correct to conclude that it had not been established that the access price which Welsh quoted bore no reasonable relation to the economic value of the service provided, that service being of course the treatment and distribution of water from Heronbridge to the site of Albion's customer, Shotton. Nor, we would submit, is this case a review of how water should be regulated; or, indeed, now, in

the light or submissions we have heard today, how well OFWAT is regulated ---- the Authority is regulated.

We heard a great deal from Dr. Marshall about why the regulatory regime that is in place fails to promote a sufficient degree of what she would consider desirable new entry. She offers an alternative model – one of unbundling – and a move away from price regulation and the introduction of new entry which might make no contribution, or would make no contribution, to the sunk costs in this industry in anything other than the pipelines.

Well, coming, as she does, from a background in electricity regulation, that may be a legitimate view, but the government does not happen to share it. More importantly – and no doubt to the Tribunal's relief – the Tribunal does not, and cannot, decide those broad political economic policy issues in this case.

So, this case, as I say, is about whether, on the facts of the case, the Director erred in concluding that the price that Welsh quoted Albion was not abusive as an excessive price.

Now, Albion tackle that in two broad ways, arguing that the price it was quoted allows it no margin, and it is, in any event, viewed objectively, excessive.

Now Albion's essential complaint is that it has no margin - that is what it is interested in – and it needs a margin to fund its activities and make a reasonable return. It is contended that it needs at least 5p per cubic metre, and hence most of the access prices that it has advanced as alternatives are understandably below that figure.

THE PRESIDENT: It says it needs 5p to carry out its retail activities.

MR. ANDERSON: Its activities, however one might describe them.

THE PRESIDENT: Yes. But, I think it has used the phrase 'retail'.

MR. ANDERSON: It has used the phrase 'retail', yes, it has. Before turning to the various issues and arguments on the level of price, I just want to pause on that question of margin because all the questions about potable and non-potable distribution, stand-alone local costs, ECPR fixed costs, those debates, must be considered in this case against the background of what Albion's business model is.

We say it is clear from the evidence of Dr. Bryan, as indeed it was clear at the time of the Decision that Albion's activities and the value it provides to Shotton occur after the water has been delivered through Welsh's system to the Shotton Mill. We would submit that the bulk of those activities, if not all of them, can only properly be categorised as consultancy services. We say they do not comprise appointed business and I will come back to that because I understood a point being made this morning was that to the extent that they can be categorised as conservation they can be regarded as appointed services, and that requires the

Tribunal to look at s.3 of the Water Industry Act, which is not in the authorities' bundle but we do now have copies. Perhaps it is a point that I could just pause at this stage and make clear to the Tribunal if I could hand up copies of s.2 and s.66 of the bundle (documents handed to the Tribunal).

It is s.3, which in fact starts on what is p.12 of 868.

> "It shall be the duty of each of the following, i.e the Secretary of State, the Director, and every company holding an appointment as a relevant undertaker in formulating or considering any proposals relating to any functions of a relevant undertaker, including in the case of such a company any functions which, by virtue of that appointment, are functions of the company itself, to comply with the requirements imposed by subsections 2 and 3 below."

Subsection 2: "The requirements imposed by this subsection in relation to any such proposals are as mentioned in subsection 1 above. (a) A requirement so far as may be consistent (i) for the purposes of any enactment relating to the functions of the undertaker; and (ii) in the case of the Secretary of State and the Director with their duties under s. 2 above …" – those are the Director's principal duties – "… so to exercise any power conferred with respect to the proposals on the person subject to the requirement as to further the conservation and enhancement of natural beauty and the conservation of flora, fauna and geological or physiological features of special interest, and in the case of the exercise of such power by a company holding an appointment as a relevant undertaker as to further water conservation. (b) A requirement with regard to the desirability of protecting and conserving ----"

THE PRESIDENT: Yes, we have read it, I think, Mr. Anderson.

MR. ANDERSON: Yes, so what is essentially being considered there is general environmental and recreational duties – that is the section, it is conservation in an entirely different meaning of the word. We would say that the activities that have been described by Dr. Bryan do not fall within the scope of conservation as it is used for the purposes of -----

THE PRESIDENT: Do we know that the entry for conservation in the list of things that we were shown is a reference to this?

MR. ANDERSON: Well the matter – and I was going to come on to that – is slightly more complicated because the word conservation is, of course, used in other contexts, such as the access guidance to which you were taken in a broader sense. We would accept, of course, that one of the duties that a regulated undertaker should undertake is water efficiency, and if one really put conservation to one side and, insofar as it is an appointed activity ----

THE PRESIDENT: Water efficiency is an appointed activity?

MR. ANDERSON: Water efficiency is part of the duties of a water undertaker, yes. But what we say in relation to that is that water efficiency is not the kind of activity that we say Dr. Bryan was describing. It does not involve the sort of situation where you have a single individual whose total employment is concerned with understanding the business of one customer and teaching that customer how to reduce his costs, how to run his business in a way that uses less water and saves him money. Water efficiency is intended to be for the benefit of the community as a whole, and not simply to save the costs of one customer.

THE PRESIDENT: Is this not for the benefit of the community as a whole. It saves water, or it is intended to save water.

MR. ANDERSON: Yes, as an obligation under the Water Industry Act, as a duty to conserve water ----

THE PRESIDENT: Does it have to be a duty as distinct from an activity?

MR. ANDERSON: One of the problems is that there is not a clear line. The point that we make is that when you analyse what Dr. Bryan has described he in fact does it goes way beyond what was ever envisaged in terms of the water efficiency that undertakers typically undertake in the industry. That is why we say in this case it is clear that what is being undertaken is a consultancy exercise. It involves an individual, an employee – I believe not an employee of Albion, but an employee of the holding company – engaged full-time in understanding the business of Shotton, of training Shotton staff, those kinds of activities which are not what is envisaged by water efficiency, or water management function as a duty under the Act.

THE PRESIDENT: This is a somewhat delicate submission you are making, Mr. Anderson, at this stage. There is widespread public concern about shortages of water, and the way that water is managed in this country, and if you are telling us that within the duties of a major water company towards its largest customer there is no responsibility to help them with their water efficiency that is quite a striking submission to make.

MR. ANDERSON: No, that is not what I said, Sir.

THE PRESIDENT: Well I just want to make quite clear what it is you are saying.

MR. ANDERSON: It is a question of where you draw the line.

THE PRESIDENT: Yes, but there does not seem to be any clear line drawn anywhere at the moment.

MR. ANDERSON: It is part of the duty of a water undertaker, I accept, to provide water efficiency services. This case, however, is about a company whose sole function is to advise an individual paper mill on how to reduce its use of water.

THE PRESIDENT: Well it only has one customer at the moment because for various reasons it has not been able to get any more.

MR. ANDERSON: But that is all it purports to do in relation to that customer. It is not purporting to provide any value or any efficiencies at any stage of the water resource treatment, or distribution aspects of the supply. All that it does could be done without it itself supplying a drop of water.

THE PRESIDENT: Where do we find something that says where the line is to be drawn?

MR. ANDERSON: You do not find anything in black and white, that is the difficulty.

THE PRESIDENT: Why is not the large industrial tariff a guide on this point? The original intention of the large industrial tariff being to supply these water efficiency services within the tariff?

MR. ANDERSON: That, of course, is the potable tariff, it was not a new tariff ----

THE PRESIDENT: For a potable customer these would be within the tariff.

MR. ANDERSON: It would be a part of it, but we would say actually in terms of the costs incurred a small part. The position here is that it is the sole function that is undertaken by Albion and that is why we say it is essentially a consultancy service.

THE PRESIDENT: Anyway, you say these statutory water companies are not expected to provide this sort of service, this tariff service?

MR. ANDERSON: Not at this level, no, and we can see that from when you look at the facts of what in fact Welsh have done both in relation to the provision of efficiency services that has fed its way through to a re-adjustment of its tariff, the efficiencies have been generated. There are, of course, continuing duties, and Ofwat continues to monitor them. That is where we are drawing the distinction at the outset, is between an activity, an undertaking whose sole activity is providing advice on water efficiency and a water undertaking part of whose duties involve water efficiency services.

So far as the delivery of the actual water is concerned, we say nothing has, in fact, changed. Albion has, we would submit, never claimed to bring any value or to have created any efficiencies in the abstraction, the treatment or the distribution of the water to the gate of the Shotton undertaking.

THE PRESIDENT: Well it is not involved in any of those activities.

MR. ANDERSON: I know it is not.

THE PRESIDENT: It is involved in the Shotton end, if I can put it that way. So you cannot criticise it for not doing something that it is not involved in.

MR. ANDERSON: I am not criticising it, I am pointing out the fact that there are no efficiencies and it does not claim to produce any efficiencies in those activities. I am sure the service it provides to Shotton is of great value to Shotton.

THE PRESIDENT: Do you not regard it as the kind of service that is valuable generally to the community and the public?

MR. ANDERSON: Well, on the facts of this case what appears to be the situation – of course, anything that reduces consumption of water is of value to the community as a whole, of course that is the case. It is particularly the case in water stressed areas, although North Wales does not happen to be one, but of course I am not saying that it is of no value to the community not to have a reduction in water consumption. But the principle beneficiary, and the principal purpose of this particular activity is to save Shotton money.

THE PRESIDENT: And indirectly to enable Shotton to survive and compete in the international group of which it is part and thus continue to be a customer of Welsh Water which it might otherwise cease to be if it became uncompetitive as it apparently to some extent is with the rest of the plants in the group?

MR. ANDERSON: Well I am not sure what the evidence is that Shotton is uncompetitive.

THE PRESIDENT: Well we have not tested it so we do not quite know it is true, but we had some indicative figures to say that it is a struggle to meet some of the productivity standards in relation to water management in the rest of the group.

MR. ANDERSON: I am not aware that the Tribunal has any evidence that Shotton is in any sense struggling or disadvantaged.

THE PRESIDENT: I am only referring to the evidence that Dr. Bryan gave in the witness box.

MR. ANDERSON: As a result of the price, the bulk supply price ----

THE PRESIDENT: It would not be of interest to a statutory water company to help a large customer be more efficient in its water supply so as to enable that customer to remain in business and compete internationally. That is not an objective the Director has any interest in pursuing?

MR. ANDERSON: Is that a comment or a question?

THE PRESIDENT: Well it is a question. It is a question.

MR. ANDERSON: Could you repeat the question?

THE PRESIDENT: Yes, the question is: is the competitiveness of the customer in international markets where water is a major production input a relevant consideration or not when it comes to considering the scope of the activities of a statutory water company?

MR. ANDERSON: Could I just take some guidance from those behind before I answer ----

THE PRESIDENT: Yes, come back to it, Mr. Anderson.

MR. ANDERSON: If I could return to my preliminary observations. Sir, the first point I was making was the contribution that Albion makes arises after the water has been delivered to the customer. It could provide every service and benefit which it does provide without itself supplying any water at all. It could provide those services without being a water undertaker at all. Those are the principal reasons why we say it is a consultancy service, and it may well be a consultancy service, it is of benefit to Shotton's competitiveness and of benefit to the wider public in the sense of reducing consumption of water. That is why we say it is essentially not an activity, a water undertaking activity at the margins, as I say – I say 'at the margins', an important activity – but an activity that merely forms part of the activities of water undertakers as normally understood. Now, the activities that Albion have undertaken have not relieved Welsh of any of the activities that it previously undertook in supplying Shotton directly. So, we would say that looked at from that point of view it is perhaps not surprising that there is no margin arising out of the abstraction, treatment and distribution elements of the supply to Shotton with which to fund Albion's post-delivery activities. It may be that there are certain downstream retail activities which Albion undertakes, and which any water undertaker carries out, such as billing. Of course, Welsh still has to bill Albion instead of Shotton. So, there is nothing changed there. There is metering. But, of course, Welsh has to meter Albion, just as previously it would have had to meter Shotton. So, on the facts of this case, we say the retail activities can really be regarded as **de minimis**.

Sir, that, we say, is the fundamental background against which all these theoretical debates about ECPR and the associated problems are to be considered. We say that once those facts are appreciated, and notwithstanding the voluminous material before the CAT, this is in fact a relatively simple case. Our case is that the valuable service which Albion provides – and no doubt costs it money to provide ---- The principle beneficiary, the direct beneficiary of those services, specific as they are to Shotton, is not the competitive process; nor is it the wider constituency of Welsh's customers or water consumers throughout the country – but, it is Shotton. One would naturally expect, therefore, for there to be a mechanism for

remuneration as between Albion and Shotton. Indeed, there is. That is the 70:30 split – albeit Dr. Bryan seemed rather reluctant to invoke it.

Of course, Albion also made great play last time round of it acting as a middle man – a sort of shaking the apple tree and generating a reduction in the price. That may well be right. But, it obtained its benefit from that because, as we were told by Dr. Bryan, they made a 50:50 deal with Shotton and remunerated Albion for that reduction in price to Shotton.

So, what competition law issues remain? Well, firstly, excessive pricing – indeed, principally excessive pricing. Is Welsh's price - the access price – excessive in the abstract, irrespective of whether or not a margin is generated for Albion? There, we say that the short answer is: whichever of the credible calculations are looked at – and we would submit that the credible calculations are the average accounting calculation and ECPR, but that if one is to start de-averaging and looking at an individual basis, a dis-aggregated basis (and we will be urging the Tribunal that that is not an appropriate course, but if one does go down that course ----), then the appropriate alternative would be stand-alone, and if one looks at those prices, the ball park figure is 20-ish and above. We say that in the light of the facts of those three methods of looking at the access price that was quoted, giving rise to 19.3 ----

THE PRESIDENT: 23.2.

MR. ANDERSON: 23.2. 19.3 as we looked at it. 23 as Welsh produced it. The ECPR and the stand-alone, which we have calculated in our Annex 2 as around 25 ---- When one looks at those, one simply cannot conclude that the access price quoted by Welsh bore no reasonable relation to the economic value of the service provided. The numerous methodologies put forward by Albion, we would submit, with the many flaws they contain – and we have set those out in some detail in our annexes (and I know a point was made this morning which we are still actually investigating because our initial investigations suggest that Albion still has got the figures wrong) ---- But, looking at the assorted methodologies that have been put forward by Albion, we say, in a nutshell, that they are simply not credible at that level.

Now, a great deal of criticism has been advanced by Albion and those representing it, and, indeed, Aquavitae, at the effective of OFWAT, the Authority, as a regulator – and, in particular, whether the approach that it has adopted is best suited to promoting new entry.

Of course, we would say that it is not the function of this Tribunal in the context of assessing whether the Director erred on the facts of this case to investigate those kinds of broad issues. But, it is worth noting that there are particular characteristics in this industry – which I will be coming back to (a high level of sunk costs, socially mandated and

desirable cross-subsidies, the benefits of regional averaging, universal service obligations, and such like) – which have to be borne in mind and taken in balance alongside the desirability of promoting competition. A lot of those issues lie at the heart of the debate on ECPR.

We would say that even in the context of that debate – where, for example, one of the principle criticisms of ECPR is that it places an undue burden on putative new entrants, that burden being of course the unavoidable fixed costs in the competitive sector (the competitive sector in this case being the retail sector) ---- simply do not arise on the facts of this case. We would say that there are simply no material unavoidable fixed costs at that level. Similarly, we would say there is simply no scope for an entrant of this kind to make any contribution towards dynamic efficiencies higher up the supply chain through distribution, treatment or resources. Of course, it is perfectly possible that new entrants can affect efficiencies, or bring benefits higher up in the distribution chain. You will recall that the position of the Director was that the inset appointment was granted on the understanding that an alternative source would be developed.

THE PRESIDENT: Mr. Anderson, that is in dispute at the moment, and it is not in the conditions of the appointment.

MR. ANDERSON: You say it is in dispute. It may be disputed ----- I fully accept that it was not a term of the appointment. I am not sure it is in dispute that a business plan was certainly submitted as part of the inset appointment in which an alternative source of supply was identified.

THE PRESIDENT: Yes. But the Director ---- I want you to put me right if I have mis-remembered it, but as I remember it the Director was not completely happy that that alternative source of supply ever would be developed. So, he did make some changes to the terms of the appointment – I think in relation to notice. He reduced the length of notice to take account of that. But, he nonetheless went on and granted the appointment.

MR. ANDERSON: That is perfectly true. But, what I am saying is that that was the basis upon which it was put forward.

THE PRESIDENT: It was one of a number of bases, and as it turns out the Shotton basis is the one that is being pursued – which the Director knew at the time was one of the possible bases.

MR. ANDERSON: All I am saying is that what was being proposed as part of the business plan was development of an alternative source through the tunnels; that the Director did have

reservations about the viability of that. No condition was attached, but a shorter term of appointment with a shorter term of notice was introduced ----

THE PRESIDENT: And he has not served any notice or revoked it or done anything.

MR. ANDERSON: No, he has not.

THE PRESIDENT: So, there we are.

MR. ANDERSON: I will say no more on that. But, that is nonetheless an illustration that there are circumstances – or may be circumstances – in which an alternative source of supply, for example, could bring efficiencies at the resource, the treatment, or the distribution level. This is not such a case on those three levels.

The technical consultancy services provided by Shotton, we say, do not and cannot contribute to any dynamic efficiencies – or, indeed, efficiencies in any other way - at those upstream levels.

If I can ask you now to turn to my skeleton argument ---- The scope of these submissions ---- The way these submissions are structured is to deal with the three broad issues that were raised in your interim Judgment. I have made the points that I wanted to make in the overview on p.4 – 4, 5, 6, and 7. What we set out in the table on p.5 are the various access prices that have been suggested, the first being the actual access price that was quoted; the stand-alone price that appears in Mr. Jones' second witness statement of 32; our decision, which you will recall there was an adjustment on the resource costs ---- treatment costs to give rise to 19.2. There is then the ECPR calculation. There is our version of the stand-alone at 25. Then there are the seven methodologies submitted to date by Albion.

Now, in a sense they fall into two broad camps. As I say, there is the 'around 20 and above' an there is the 'around 5 and below'. The Tribunal might ask itself, "Well, are there any pointers that we can look to to suggest which general ball park is likely to be the more credible general ball park?" We say that there are indicators, and those indicators that we would identify are the following: that the majority of large non-potable customers pay in the range of 20p to 30p per cubic metre. You can, for example, see the second bulk supply price was, or is, 26p.

THE PRESIDENT: We were told 15 to 30 last time.

MR. ANDERSON: I am sorry . You are right – it is 15 to 30, but the majority in the 20 to 30, I think is how it was put in the skeleton argument last time. Those can be seen from the comparators that the Director used in making his quasi-determination of the second bulk supply price where he looked at a series of comparators – a total of ten comparators. He put aside four of them for perfectly logical and sensible reasons – that is because for three of

them the prices included contributions towards capital costs, and in relation to the fourth there was the provision of balancing lagoons, which provided an additional reason for reducing the price. But, the remaining six that were used as comparators were all in the range of 26p to 29p. The new tariff for non-potable distribution, for non-potable supply, is 26p. The price to the neighbouring customer is 26p less the value of the lagoons, and the final indicator is that of course Albion's own case advances the sum of 5p as being necessary for the retail activity, an activity that involves no sunk costs, no fixed costs, yet the activity for which it seeks access involves a treatment facility as well as a distribution network. So we say with those broad indicators in mind the first of the two camps we would suggest is quite clearly the more credible. That is essentially the point which we make in para.8. The table appears again a few pages further on at para.21, where we have summarised the principal reasons why we say the methodologies that have been submitted by Albion are themselves flawed as well as being, in our submission, not credible.

So the case on excessive pricing now boils down to three points: first, whether Albion has succeeded in demonstrating that the potable and non-potable distribution costs are not the same, whether they have shown that and we say they have not, despite the arguments, the methodologies, the witness evidence, we say that the balance of that evidence has failed to demonstrate that there is a material difference in the costs and accordingly the Director was correct to accept the basis upon which Welsh had made their calculation, namely, that the were was equivalence in the distribution costs as between potable and non-potable distribution – that is a matter that I will be coming back to.

The second point is whether the first access price can be shown to be excessive in relation to some kind of local or stand-alone cross-check. Our position is that we submit that such a cross-check is neither necessary nor appropriate for price determining in the water industry. Prices are not based on a stand-alone basis and that is for very sound policy and practical reasons which again I will come back to. Stand-alone or local cost data is inherently unreliable. But we say if the Tribunal is minded to go down that route then we would submit the appropriate methodology is a stand-alone methodology, not a bottom-up local cost methodology and if one undertakes such a calculation and the Director has endeavoured to do so in the light of the information provided by the two parties in dispute, the figure that one arrives at is 25p m^3. So we would say that the stand-alone cross-check, if it is to be undertaken supports rather than undermines the Director's ----

THE PRESIDENT: We did ask for submissions on whether it should be done at all.

MR. ANDERSON: That is my de-averaging, regional averaging, de-averaging point. We do not believe that a de-averaged local cost is an appropriate pricing methodology at all, because of the knock-on effects, the winners and losers' points and I know the Tribunal is concerned – and rightly concerned – about the impact of water pricing on commercial undertakings and their competitiveness, and that is of course an issue.

THE PRESIDENT: You let it unfold, Mr. Anderson, but I think we will want to discuss a little later on how far the Authority feels that it is necessary further to disaggregate costs to look at various types of activity, either in the Chapter 2 context or in the Water Act 03 context which we are treating as roughly equivalent for this purpose.

MR. ANDERSON: Do you mean disaggregate as between levels of activities or ----

THE PRESIDENT: For example.

MR. ANDERSON: -- or disaggregating on a local distance?

THE PRESIDENT: Well there are two things. There is the local basis with what we were on originally in part at a stage where it was being accepted, I thought, by Albion that the Ashgrove cost would reflect regional costs, but there is also the question of knowing more about costs in relation to the costs of the pipeline, and the costs of other upstream activities, and the costs of any relevant downstream activities, than we seem to know at the moment, which it does not seem to be very much.

MR. ANDERSON: I think one of the difficulties, Sir, is that the nature of this business is that the actual sunk capital costs and the common costs are such a high proportion of the total costs and the operating costs of an individual system are such a small proportion ----

THE PRESIDENT: Yes.

MR. ANDERSON: -- that it is inherently difficult to disaggregate.

THE PRESIDENT: It may or may not be but it has not been necessary to think about it until very recently, I suspect, and the question is whether one should think about it a bit more now one has a competition regime of sorts and one has the potential application of the Chapter II prohibition.

MR. ANDERSON: Well, when you say 'recently' you mean before this case?

THE PRESIDENT: Well this case has perhaps highlighted that whether we are talking about the Water Act 03 or the Competition Act, the question of asking oneself whether the price of a particular activity is related to its costs and what one means by 'its costs' and whether you can look at activity separately and, if you do, how you should account for common costs are questions which have never really needed to be explored in any depth before in the water industry – or, for whatever reason, have not been explored, because as Mr. Jones very fairly

told us that is not the way that companies look at it because it is not something they have ever had to look at or something that is required by the existing regulatory regime.

MR. ANDERSON: That is something I will ----

THE PRESIDENT: But let us come back to that because I do not want to take you out of your stride, because you are taking us very helpfully through your skeleton.

MR. ANDERSON: The third point, of course, is the debate about ECPR methodology. The point I make in para.11 is that the question as put by the Tribunal is how far it was open to the Authority to use ECPR to negative a possible infringement by Welsh or the Chapter II prohibition and we think that is a slightly unfair way of putting it.

THE PRESIDENT: Yes, that particular question can be rephrased.

MR. ANDERSON: However it is phrased we say it was appropriate for the Authority to consider access price under an alternative methodology ----

THE PRESIDENT: The point as framed at 427 is the compatibility of ECPR as applied in this case with Chapter II, that is what we said in 427.

MR. ANDERSON: Yes. The point that we make is that it was a perfectly reasonable methodology to adopt.

THE PRESIDENT: Yes.

MR. ANDERSON: It would have been, I would suggest, verging on the perverse if the Director had not considered that issue at the time that he was taking this decision in 2004, given -----

THE PRESIDENT: When the Water Act was already in force.

MR. ANDERSON: -- his view and, we would submit, the only reasonable view of the construction of what the cost principle is.

THE PRESIDENT: Yes.

MR. ANDERSON: A great deal of consideration, consultation, debate had gone on on this subject in the months between 2000 and the time when this Decision was taken.

THE PRESIDENT: Yes.

PROFESSOR PICKERING: Mr. Anderson, while you are on para.11, something that I noted in what you have written there, and I would just like to ask you about, is your comment that an excessive pricing determination involves a considerable margin of appreciation. I just wonder whether you have a view as to the appropriate proportionate size of that margin of appreciation?

MR. ANDERSON: It is very difficult to put my finger on an actual percentage. What we undertook was a number of exercises which came to a figure that suggested that the 23p that was quoted was within that margin. Now, if you are asking me whether, had we only

looked at it from the point of view of the average accounting cost, and come out with our figure of 19.3 compared with the figure of 23, would that have been a sufficient difference for us to conclude that there was excessive pricing? I am not prepared to say because it is not what we did. We undertook both exercises, that is why it is not right to regard it as a cross-check to negative a potential infringement. We undertook both exercises and looked at the position in the round and took the view that it could not be said that the access price that was quoted bore no reasonable relation to the economic margin. It is very difficult to say what the brackets of that margin of appreciation are, and I am not in a position to give a percentage or a point at which one moves from the margin into excessive pricing. It depends on a number of circumstances, a number of factors.

PROFESSOR PICKERING: While this is the case that has come to the Tribunal, I imagine that this would not have been the first occasion, or indeed the last occasion on which the Authority would be needing to have a view, and to do some cross checks, and I just wonder whether it has identified a rule of thumb in terms of proportionate variations that it would say "Well, these are in the noise but others might at least prompt us to do even more work to consider."

MR. ANDERSON: I will ask those behind me to consider if there are specific instances. I do not know, but I am not yet aware of any guidelines that have been set out. I am aware of course that this was the first case in which they had to consider an access, so they had no precedents, if you like, to go on in relation to this particular situation. There are situations for example, where it had to determine the second bulk supply price, or would have had to determine it if the parties themselves had not decided we will agree this rather than go through the hassle of a formal determination since the Director has given his indication. But you will recall that the scope there was between 26 and 29. So the 3 or 4p bracket, when one is talking of figures in the mid-20s appears from what one can see on the matters that have been considered in this case to have been within that general area of appreciation. Of course, it is a two-fold margin of appreciation. There is a margin of appreciation in terms of when a price bears no reasonable relation to its economic service then there is a margin of appreciation on us that you, as a Tribunal, need to afford to us in taking a judgment on that. It may have been, speaking hypothetically, that we had taken the view that this price was just on the edge, and if it had been a little bit higher, then we would have been in no doubt. But, they just got away with it. It could have been that our position was, "Well, this falls broadly within the middle. We are content with it". It could have been that our position, "Well, clearly, this isn't an excessive price." So, there is that margin.

THE PRESIDENT: A lot is going to depend on the circumstances, is it not, Mr. Anderson?
MR. ANDERSON: Yes, of course.
THE PRESIDENT: An apparently small difference might mean a lot in cash terms, or might mean nothing. It might be **de minimis**. A large difference may be less relevant than it appears at first sight for other reasons, or whatever.
MR. ANDERSON: It may be that other factors will take into account such as what has happened in the period leading up to the point at which one is making the decision.
THE PRESIDENT: Yes, all sorts of things.
MR. ANDERSON: We day then, at the bottom of p.7 – and I am sure I will be moving much faster when I get beyond this initial period – so, an hour is not to be taken as an indication of how long it will take me to get through the whole document ----
THE PRESIDENT: Shall we take a break when we get to p.10?
MR. ANDERSON: Do you mean some time tomorrow morning? (Laughter)
THE PRESIDENT: We are entirely in your hands, Mr. Anderson.
MR. ANDERSON: We say it was open to the Authority to use ECPR and that is an established methodology which has been used in other industries. You have heard the debates and seen the reports and the circumstances. We say a retail minus is the approach that has been adopted, and Community law neither prescribes a particular access pricing methodology, nor precludes it. It might at that point be worth reminding the Tribunal that, of course, England and Wales is unique in the entire community in having attempted to introduce even any element of competition into the water industry. Water industries throughout Europe normally, run by local authorities, have not introduced any level of competition. So far as we are aware, they all use regional average pricing bases in the sense that customers are not charged on cost-based, or distance-based, models albeit I think it would be fair to say that the number of water undertakings in other member states tends to be much larger. There tend to be many more of them. So, in fact, your regional averaging will be tending to get closer to local, albeit there is no distinction draw between the customer that happens to be up the side of the mountain and the other that is right next to the ----
THE PRESIDENT: My impression is – though it is a very broad and anecdotal one, and others in the room will know much better – that most mini continental industries rather resemble what we had in this country until just after the Second World War, with a series of rather localised, very often municipal undertakings.
MR. ANDERSON: Yes. You may recall that appended to Professor Armstrong's report was an annexe that we prepared. In that, we referred to a paper given by DG Competition in the

Summer of 2004 on the subject of competition in which he (and we can hand in copies if the Tribunal has not itself obtained them – I think they can be found on the Commission's website – we have only footnoted it; we did not append it to that) he gives some indication of why it is, in his view at least, that the water industry is not best suited to the sort of rampant competition that in other industries it is desirable to pursue. I think there was a discussion with Professor Armstrong about the cautious approach.

There are particular characteristics of this industry that make it more difficult to open it up to competition in all sectors quickly and enthusiastically.

THE PRESIDENT: But, we have a parliamentary decision, apparently, to open it to competition in one sector in respect of certain activities. That is where we are.

MR. ANDERSON: Yes. But, open it up with a pricing regime that has certain safeguards built into it. We would say that is the costs -----

THE PRESIDENT: That slightly begs the question of what the costs principle is, but your submission is that this is ----- Well, I think it is implicit in your submission that the effect of the costs principle is, as you construe it, to open up this sector, either more gradually, or even less, to competition than might have been the case had you had a different principle, i.e. that the costs principle has a restricting, and is intended to have a restricted, effect on opening the market.

MR. ANDERSON: This government, over the last couple of decades, has opened up a number of network markets to competition in different ways. It appears to have adopted a fairly conservative approach to this industry. When I take you to the characteristics of the industry that we say are relevant to that, it may become clear why that is the case. There are differences. With the greatest of respect to Dr. Marshall, she is not an expert in this particular industry, and her views are primarily based on the fact that all network utilities ---

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THE PRESIDENT: Let us go on and explore in due course what the differences are.

MR. ANDERSON: As to the issue of margin squeeze, we say that the European law on margin squeeze does not mean that any entrant is entitled to be subsidised by incumbents. What we mean by that is that unless the new entrant makes a contribution in the context of the pricing regulation that has been ---- the regulatory regime that has been created for this market ---- unless the contribution to the fixed costs in the competitive sector is made, then they are effectively ---

THE PRESIDENT: In the competitive sector?

MR. ANDERSON: In the competitive sector. If the fixed costs in the competitive sector are made, that entry will not only be inefficient in the sense that Professor Armstrong described – because it will involve duplication, and therefore an increase in total industry costs – but it will also involve subsidising by existing customers in the sense that the revenue required to fund those assets will have to be obtained from other customers in the market.

THE PRESIDENT: I think we can follow entirely the need to cover the fixed and common costs in the "monopoly sector" and the need to fund universal service obligations and so forth, and so on, subject to what exactly one includes in that. But, to fund the incumbent's costs in sectors that, by definition, have been open to competition is taking it one stage further, is it not?

MR. ANDERSON: We are only talking about unavoided fixed costs over ----

THE PRESIDENT: Over what period of time?

MR. ANDERSON: Well, we would be happy to accept the proposition that it should be the medium to the long-term. But, insofar as the costs are sunk ----- I mean, the point that comes clearer in a situation, or in a sector, where there are in fact relevant sunk costs ---- It is not the retailing sector. This is not an issue, we would submit, in the sector in which this entrant is seeking to enter.

THE PRESIDENT: So, no entrant should be expected to support an incumbent's retail costs. Would that be too broad a way of putting what you put?

MR. ANDERSON: That would be too broad. What I was seeking to do was to explore the proposition in another sector that has been open to competition – for example, the resource section, where you may have fixed costs – a reservoir - which will nonetheless require funding. The costs of it cannot be avoided. Therefore, if the use of that is somehow displaced or stranded as a result of new entry, it still needs to be financed and funded, and the only source of the revenue for the funding is, of course, the rest of the industry. That is the way the pricing mechanism operates. The funding for that will therefore inevitably be ----

THE PRESIDENT: That is the stranded asset case. Query whether it is relevant to the present case, but that is the stranded asset case. At the retail end, if, as I thought you had said a moment ago, there are not any fixed costs – at least over the medium to longer term – why should any third party support the incumbent's costs in that area? He can simply adjust his costs down to a more competitive level.

MR. ANDERSON: They are not.

THE PRESIDENT: They are not?

MR. ANDERSON: In that situation, where there are no unavoidable fixed costs at the retail level, any costs that are incurred will, by definition, therefore be avoidable and will therefore be deducted from the access price.

THE PRESIDENT: Is that reflected in the guidance that the Director has given – in terms of the zero margin figures, and things that we have seen?

MR. ANDERSON: I will come back to those zero margin figures. I am not sure I fully -----

THE PRESIDENT: We are just struggling to understand.

MR. ANDERSON: Not only did I not fully understand them, but I am not sure that we have got a complete copy of what was attached to Dr. Marshall's report. We understand their Aquavitae creations.

PROFESSOR PICKERING: Just a quick question: in this case who is determining the retail price?

MR. ANDERSON: In this case, we did.

THE PRESIDENT: You mean the retail price to the customer or the retail price to ---- or the price ----

PROFESSOR PICKERING: The retail price to the customer. You determined the retail price -- --

MR. ANDERSON: Effectively. We quasi-determined it.

PROFESSOR PICKERING: You have also determined the access price.

MR. ANDERSON: No, we have not determined ----

PROFESSOR PICKERING: You have taken a view as to what is a reasonable access price.

MR. ANDERSON: No. We have applied a formula which is to remove the avoidable costs. What those happened to be was a result of what Welsh was paying United Utilities. We applied a formula which was to deduct the avoidable costs from the retail price. The retail price, I accept, was set by us. Welsh had no choice in relation to that. That was the quasi-determination. Then we applied a formula. So, we did not take a view as to what was ---- We have not taken the view that having done that, we could see that the access price that had been quoted and calculated on an alternative basis was reasonable, given that the ECPR approach came to broadly the same result. That is what we did.

PROFESSOR PICKERING: Well, ECPR was the formula.

MR. ANDERSON: Yes.

PROFESSOR PICKERING: But, your initial assessment of the reasonableness of the access price was actually determined on other bases.

MR. ANDERSON: Those other bases being?

PROFESSOR PICKERING: Well, AAC, for example?
MR. ANDERSON: Well, yes, that is correct. It is true that from now on the basis will be ECPR, assuming we are right on our construction of the costs principle.
PROFESSOR PICKERING: It is pretty unusual, is it not, to have both the access price and the retail price effectively being - I understand you do not like the term 'determined' – the subject of a decision by the same body.
MR. ANDERSON: Well, it is a regulated industry. I do not see what is strange about it at all, with respect, sir.
PROFESSOR PICKERING: Well, it is a regulated industry that is being expected to live with a parliamentarily introduced desire to establish some competition in the industry.
MR. ANDERSON: The duty on the Director is to promote effective competition where appropriate.
PROFESSOR PICKERING: I agree with your word. The word is 'effective'.
MR. ANDERSON: Yes.
PROFESSOR PICKERING: That is not necessarily identical to the term 'efficient' as used by people like Professor Armstrong, is it?
MR. ANDERSON: Well, the view has been taken by DEFRA and the government that efficient entry is a good thing. Entry that increases overall industry costs or imposes a burden on existing customers is not appropriate at this stage for the water industry. It is in the light of that that we have approached our functions under the Act to promote, where appropriate, effective competition.
THE PRESIDENT: Mr. Anderson, when you tell us – and it is mentioned a number of times in the skeleton – that 'the view has been taken by DEFRA and the government', on what basis are you inviting us to accept that, other than what is in the documents that we can read for ourselves. Should we not have some evidence from the Secretary of State or somebody as to what the view is?
MR. ANDERSON: Well there is nothing more than is in the documents.
THE PRESIDENT: Right, that is what you rely on? That is how ----
MR. ANDERSON: Mr. Morley, which I will take you to in the House of Commons ----
THE PRESIDENT: That is the inference that you invite us to draw from those sources.
MR. ANDERSON: Yes.
THE PRESIDENT: Shall we just rise for five minutes? I am sorry, did I catch you off ----
MR. ANDERSON: No, that is a perfectly good point, but I think Professor Pickering may have had a further question.

PROFESSOR PICKERING: I was going to ask whether you would agree that there is in fact a tension, at least prospectively, between the concept of efficient entry and effective competition?

MR. ANDERSON: There could well be a tension but, as I say, there were broader issues that arise in the context of this industry that is simply promoting new entry, efficient or otherwise, and the dynamic – for example, there is a view that the scope for dynamic efficiencies in this industry are fairly limited. One can see, for example, a distinction between the scope for technological innovation in the telecoms' industry which is not actually available here. I think Dr. Bryan himself accepted in his evidence that such scope as there is for innovation is really in the domestic side – things like recycling dirty water – not really on the non-potable side.

THE PRESIDENT: It was not obvious in telecommunications in 1986 when the market was open that there was much scope for innovation, in fact, BT argued very strongly that there was not.

MR. ANDERSON: Well, I accept that, as a matter of policy, you need to strike a balance as to whether you think realistically there is a prospect of dynamic efficiencies being generated that justify increasing total costs in the short term. At the moment the view has been taken that that trade-off is not worth taking.

PROFESSOR PICKERING: But Dr. Marshall made, I thought, a very interesting point yesterday what with dynamic competition it is actually something that is terribly difficult to foresee and if a regulator is seeking to determine whether we will or will not get dynamic benefits out of a competitive situation then it seems to me that we are in danger of going back to all the problems from earlier days of economic and industrial policy about trying to pick winners. Sometimes, and perhaps often, it is as well to create the favourable environment, and to see what happens rather than to take the view that nothing will happen and therefore not to allow the creative environment to do its work.

MR. ANDERSON: Well, you may be right, Professor. This may be an extremely interesting debate, but of course the bottom line is we would say there is no scope for dynamic efficiencies being generated in the distribution treatment and resource water activities by the introduction of the consultancy advice services in this case on water efficiency, nor are there fixed costs at the retail level that create the problems that give rise to the need to take those policy decisions in a broader scope.

THE PRESIDENT: Can we leave it there.

PROFESSOR PICKERING: I am sure we should.

MR. ANDERSON: We can pick it up in 10 minutes.

THE PRESIDENT: Thank you very much, Mr. Anderson.

(Short break)

THE PRESIDENT: We did not actually get to p.10 after all.

MR. ANDERSON: No, I know, well it is very ----

THE PRESIDENT: It is useful discussion.

MR. O'FLAHERTY: Sir, if I could just apologise on Mr. Thompson's behalf, he is trying to determine what his commitments are for the morning at the moment.

THE PRESIDENT: Fine, thank you.

MR. ANDERSON: Could I just correct a couple of points – points that arose in the course of questions to me? The first is that our understanding is that the sole basis upon which any business plan was put to us was on the basis of the alternative source and, secondly, of course, the right to terminate the licence does not rest with us, it rests with the National Assembly of Wales.

THE PRESIDENT: At the time it rested with you and you granted the licence.

MR. ANDERSON: At the time that we granted the licence it was the Secretary of State.

THE PRESIDENT: Well whoever it was.

MR. ANDERSON: Yes – never us. Margin squeeze – para. 12 – we say there is a distinction between this case and cases such as *Genzyme and Deutsche Telekom* because we say here there is no scope for margin because the new entrant is not replacing a service provided by the incumbent, and we have set that out in our written submissions as to the distinction between this case and those sorts of cases. It is also a point that is dealt with by Welsh and I will come back to it briefly but not in great detail at a later stage.

In the course of the interim Judgment the Tribunal made some preliminary observations about the lack of the competition in the water industry and I would like at this stage to take the Tribunal to Annex C to Professor Armstrong's report, which is a paper prepared by Ofwat; it is entitled "The efficient component pricing rule in the water industry", but it sets out the characteristics of the water industry. Beyond a few minor comments made by Mr. Jeffery in his second witness statement about informational inadequacies in terms of data collection, it has not been challenged or disputed, or anything put in to suggest, that it is inaccurate. I would like to take you very quickly through it, because I think it is important.

MR. THOMPSON: Sir, as a point of information, as far as we were aware, it was not actually Professor Armstrong's evidence.

MR. ANDERSON: I did not say it was. I said it was prepared by OFWAT.

MR. THOMPSON: But, he did not testify that it was accurate. It was simply appended to his report. Yes?

MR. ANDERSON: It is an OFWAT report.

THE PRESIDENT: It is appended to his report.

MR. ANDERSON: He identifies it as the source of his information on the water industry. That is why it is appended to his report. The relevant features of the water industry - p.2. Does the Tribunal now have it? (After a pause): The first point is that under prices, "retail prices have been regulated in the water industry by means of a price limit on the annual overall charge and a basket of prices". We were taken through the way in which the price determination document operates. Efficiency. The price limits set out in that mechanism reflect challenging efficiency assumptions for the appointed water companies in all aspects of their function. So, the mechanism – the price regulation – seeks to generate efficiencies through the way in which it operates. Capital expenditure – also challenging targets are set based on the regulator's assessment of companies' relevant efficiencies. Then there is an explanation of what happens if companies over or under-perform.

At para. 8: "OFWAT believes most of the easy efficiency savings have been made and there is scope for future efficiency gains is smaller". That is reflected in the lower continuing efficiency assumptions for operating costs in the 2004 price determinations to which you were taken.

The next feature, if I could take you over the page, on p.4, is cross-subsidies.

> "Retail tariffs in the water industry reflect geographical averaging within each appointed water company's area for each customer class, e.g. large users or domestic households. Typically there is a cross-subsidy between low cost, often urban, customers and high cost, often rural, customers. Regional average charging by companies is consistent with the Director's duties and the government policy".

That is a point, sir, that you put to me a couple of days ago about regional averaging within customer classes – the customer class, of course, being large non-potable customers.

THE PRESIDENT: I think we will get to it, no doubt, in due course, and it is an interesting topic – this particular one. I think it is very appropriate, in para. 11, for OFWAT to point out that although we can slip into the phrase 'regional average charging' which has a sort of nice, bland sort of sound to it, we are actually talking about 'company average charging' which is a different idea. So, the company average within Dee Valley, and within United Utilities, and within Dwr Cymru could be different presumably because it is within the different companies.

MR. ANDERSON: Of course. As between them there will be differences, yes.

THE PRESIDENT: It is just within a company it is not -----

MR. ANDERSON: It is within a company because a company is appointed for an area. So, it is within an area – hence the term 'regional'.

THE PRESIDENT: Yes. But, where the company is, and, as we have seen in this case, which bit is within which company, can be a bit arbitrary. Shotton could be in any one of three different companies, as far as I can see from the map, but it happens to be in Dwr Cymru. However, parking that --- The conceptual problem, with which I at least have a certain amount of intellectual difficulty, is that the Director's various MD publications over the years encouraged the introduction of common carriage, or consistently said how important it was to get some competition going. The Water Act 2003 now takes that further . If that is to have any meaning for the customers that are open to competition – the larger industrial customers – that must surely inevitably have some weakening effect on the principle of company-wide average prices. You cannot have them both. They are just not compatible as a matter of logic, I would have thought.

MR. ANDERSON: I come back to it. I do not think we would accept that proposition. We can see, in relation to that individual customer that if the access charging is based on regional average pricing, all that has happened is that the particular costs that have been avoided by the incumbent of supplying that customer, have been avoided and are deducted, then the regional pricing as a rule, across the region., will not have been affected.

THE PRESIDENT: If it is going to work at all, and we have seen only today in a House of Lords report how anxious the Chairman of the Authority is that it should work it can only work on the basis that some customers will get lower prices ---- some end customer will get lower retail prices because if there is a margin, and people can come in, the effect will be that somebody will get a better price, and that is going to mean that not every customer is on the regional average any more.

MR. ANDERSON: It may be a different price. It may be a keener price. It may be some other ---

THE PRESIDENT: But it cannot be a regional average price. As soon as you let people in you have really said 'goodbye' to regional averaging as a universal rule.

MR. ANDERSON: You say 'goodbye' as a universal rule ----

THE PRESIDENT: I am simply trying to understand it at the moment, Mr. Anderson.

MR. ANDERSON: I quite see that if there is a situation where efficient entry is profitable, and a new entrant comes in with a margin that enables him to reduce the price to that customer.

That customer will then benefit in a way that the rest of the customers who are on regional prices will not have benefited.

THE PRESIDENT: That seems to be one of the objectives of the system.

MR. ANDERSON: One of the objectives.

THE PRESIDENT: If you can get over the ECPR hurdle, then the result will be to weaken regional averaging.

MR. ANDERSON: But, there is a trade-off because the system will operate where that new entry is efficient – that is to say, it has contributed to an overall reduction in total costs in the industry. That is considered to be, in broad terms, for it is a policy issue, desirable. What is considered less desirable is entry that increases the total costs of the industry, even if for the sake of seeking to generate longer term dynamic efficiencies which it is believed in this particular industry may be less realisable – or, less likely to be realised than possibly in other industries.

THE PRESIDENT: When you say 'it is believed', it is hard to read the ---- Is that the inference that we draw from the consultation paper which talks about scope for competition – particularly non-potable -----

MR. ANDERSON: A combination of ------

THE PRESIDENT: … (overspeaking) … innovation and lower prices, and all sorts of things.

MR. ANDERSON: The combination of the consultation paper and the fact that the government has chosen to introduce the costs principle ---- Now, I know it all pre-supposes that you accept my proposition that the costs principle is a form of ECPR, but if it is a form of ECPR that operates in the way that we say it operates, that necessarily means, we would submit, that the approach that has been adopted is the approach that has been elucidated by Professor Armstrong – that is to say, it facilitates, or makes profitable, only efficient entry in the sense that it is entry that reduces total industry costs. That is why whatever the merits and views that Dr. Marshall may have about an alternative model being preferable from the point of view of consumers, the government has not shared that view, and has chosen a different route. So, I fully accept that the route that has been chosen may be a cautious or conservative route to the introduction of competition, but that is the decision that has been taken. That is the approach – because there are particular characteristics in this industry which is what I am taking you through at the moment.

THE PRESIDENT: Let us press on for the time being.

MR. ANDERSON: Paragraph 13 is a reference to environmental and other obligation.

"In discharging their duties, appointed water companies are required to operate in accordance with the terms of permits designed to protect the environment. The provision of regulatory information. OFWAT collects extensive information on water companies' costs in order to regulate prices in performance and, in particular, to carry out comparative efficiency analyses".

Now, the principle efficiency analysis that is carried out is done so on the basis of potable water, which is why, for these comparative purposes, non-potable distribution costs are treated differently for the purposes of extracting this information, but that is because one wants to be able to compare on a like-by-like sensible basis. That is a point that we mention in the skeleton to address a concern that the Tribunal had about the different treatment of potable and non-potable costs in the regulatory reporting requirements.

Moving from price to capital and operating costs, the water industry is highly capital intensive. Then we set out some figures there to demonstrate that. You can split the average household water and sewerage bill roughly into 40 percent for operating and 20 percent for capital, and 33 percent for return on capital.

The next point is 17: "Due to the capital intensive nature of the water industry and the large ongoing investment programme an increase in the costs of capital has a relatively large effect on industry costs". That is a relevant point when one comes to consider matters such as cost of capital and capital value. So, the funding of capital investment ---- "OFWAT analyses appointed water companies' proposed business plans at the periodic re views." At para. 19: "In the five year period 2000 – 2005, the aggregate net cashflow for the appointed water companies before financing was 6.7", and then the paper goes on to say,

"A constant feature of the water and sewerage industry in England and Wales since privatisation has been that industry revenues are less than industry expenditure. This has been mainly due to the large amount of capital investment that has been required. The gap between the two has been covered by borrowing".

Now, that is a particular feature of the industry – a necessary and ongoing feature of the industry that has, of course, to be borne in mind when one is considering just what are the scopes for price competition.

Then, at para. 20 ----

THE PRESIDENT: This is a sort of cement-maker's point, is it not?

MR. ANDERSON: Yes, but this is, on the other hand, a regulated industry and we regulate it having regard to the fact that water companies have to spend more money than historically revenue has generated. There is a lot of catching up to do in mending these leaking pipes.

THE PRESIDENT: There are lot of private sector companies with large investment programmes that have to be dealt with out of borrowing rather than paid for out of cash.

MR. ANDERSON: And a lot of companies go bust, or withdraw from markets.

THE PRESIDENT: Yes.

MR. ANDERSON: Paragraph 20 is a stranded asset point, which you have had rehearsed significantly. Of course, it does not specifically arise in this particular case, although of course this isolated system that Professor Pickering, in particular, was putting to Dr. Marshall simply illustrates, as a matter of fact, how easily an asset can become stranded – serving only two customers ----

THE PRESIDENT: How would it become stranded ---- how does common carriage strand an asset?

MR. ANDERSON: Common carriage does not strand an asset.

THE PRESIDENT: That is what we are talking about in this case.

MR. ANDERSON: Well, partial stranding is what is addressed by ECPR. Bypass, of course, it does not address. That is the point Professor Armstrong made clear.

THE PRESIDENT: How does partial stranding arise from common carriage?

MR. ANDERSON: If an asset is stranded, its costs are not avoided. The asset still has to be funded.

THE PRESIDENT: Yes. But, how, in a common carriage situation, is the asset stranded?

MR. ANDERSON: Well, for example, if you obtain an alternative source of your water to supply to an existing customer who was supplied by an existing source of water – for example, a reservoir ---- Two reservoirs serving the Ashgrove system, for example: the water in one is designed for Corus; the other designed for Shotton. Albion comes along and says "I've got an alternative source of water from boreholes that I intend to bring down the tunnel". Therefore, that asset is no longer needed; that reservoir is no longer needed. That is how it would be stranded. The cost of it would not be avoided.

PROFESSOR PICKERING: That assume that the owner of the asset that is at risk of being stranded does not realise the desirability of adjusting the price for access to that asset in order to keep that asset in use. Furthermore, the problem – as again I think I was putting to Professor Armstrong and Dr. Marshall yesterday - of losing a customer is as much about that customer perhaps no longer being able to stay competitive as a result of input costs of

which the cost of water in some productive processes could be a significant one. So, again, the issue is, at least to some extent, is it not, in the hands of the incumbent to ensure that its customer, either directly or indirectly, remains viable, and therefore remains a user of the asset so that it does not become stranded?

MR. ANDERSON: I understand that, but I think the phrase that Professor Armstrong also used was that 'the incumbent's hands are tied'. There is, in fact, very little scope for incumbents to respond in the way that you are describing, which is the way that you would expect a supplier, facing the loss of a customer, to respond to a competitive threat.

THE PRESIDENT: But why is that so, Mr. Anderson, because you have got the special agreements regime? The normal effect of competition is to bring price close to cost. Why can a process of that kind not operate within the context of the special agreements regime?

MR. ANDERSON: The special agreements regime, as you call it, is a historical throwback. Companies are moving from special agreements to ---- Special agreements have been inherited ----

THE PRESIDENT: You want to apparently get them on to tariffs ----

MR. ANDERSON: Yes.

THE PRESIDENT: -- but it is coming back to the point we were on a moment ago: the logic of competition is to move off tariffs because customers who benefit from new entrants charge non-tariff prices, and if you want incumbents to respond to that, then either the whole tariff has got to come down – which might happen – or (which we gathered in the Bathhouse case had happened) you have got to have a situation of local negotiation, which is in most utilities the typical situation for most large industrial customers.

MR. ANDERSON: I understand that. The first point I was making was simply to make it clear that there is not a special agreements regime.

THE PRESIDENT: Well, there is, because it is in the statute. It is still there. Nobody has abolished the statute. You have apparently taken the view that you would rather have some tariffs, but that just happens to be a view – and a view apparently taken before the 2003 Act came into force.

MR. ANDERSON: Yes. The policy is to move to tariffs. I can see the points that you are making as to what the effect of introducing competition would be on tariffs. That is why, as a matter of policy it has been decided to approach the introduction of competition cautiously. The benefits of tariffs, regional tariffs, undertaker-based tariffs, the benefits of that are considered to be significant.

THE PRESIDENT: Mr. Anderson, in this case for non-potable customers when this complaint was made there was not a tariff for large non-potable customers, that arrived half way through the proceedings.

MR. ANDERSON: Yes.

THE PRESIDENT: Even now, we now learn, the introduction of that tariff is contested by the largest overall customer of Dŵr Cymru's Corus, and it does not apply to at least one other, and this present case is disputing it in relation to Shotton, so I do not quite see the effect of this tariff and if you then add in the further ingredient of competition just as a matter of logic it is very hard to see what the benefit of the tariff is.

MR. ANDERSON: There is a dispute between Ofwat and Corus that is being litigated to which I do not propose to go today.

THE PRESIDENT: That is quite fair.

MR. ANDERSON: There is a point that is being made by Mr. Thompson in relation to another customer on a different price and again that is a matter to which I do not propose to go today, that is between those customers. There are bulk supply agreements and a mechanism for determining them, which is what applies between these two customers. One was quasi determined, the other is now on a tariff with the deduction for the value of lagoons it produces, so it is in a different position.

THE PRESIDENT: But if we take large industrial customers and occasionally this case has been bedevilled by considerations of household customers and so forth which, as far as the Tribunal is concerned, has nothing whatever to do with it, but if we take large industrial customers you have got Shotton on the Dee Estuary just outside Chester, you have a refinery down in Milford Haven that is 200 miles away, you have some very important steel plants in South Wales, the last remnants of a once great industrial economy. What have those various activities got in common that it is so important that they should be regionally averaged?

MR. ANDERSON: We have explained in an entire annex why it is the regional average ----

THE PRESIDENT: Yes, but why was it not thought of until 2003 in the middle of this case? If it was so important why was it not done years ago?

MR. ANDERSON: Regional averaging as far as I am aware has always been the basis ----

THE PRESIDENT: Not for these customers, these large non-potable customers.

MR. ANDERSON: Back before privatisation – well ----

THE PRESIDENT: That was in 1989, if we fast forward to 1999 it is still not there. It is only when this case is half way through that somebody thinks of it.

MR. ANDERSON: I do not think that is fair, Sir, it is not while this case ----
THE PRESIDENT: All right, we have the large industrial ----
MR. ANDERSON: That has always been the policy but it has been a policy that is set against the fact that the special agreements happen to exist. They were inherited. They had to expire ----
THE PRESIDENT: They may not have been satisfactory in themselves, that I can see.
MR. ANDERSON: Absolutely, some of these agreements dated back many years and were inherited by the water companies.
THE PRESIDENT: Why should the steel works subsidise the oil refinery should subsidise the paper mill, to put it another way? Or vice versa?
MR. ANDERSON: That is one way of putting it. We have described in an annex to our skeleton argument in some detail what the benefits of regional averaging on a distance basis are. The principal reasons are that the pipes are where they are, the plants are where they are, investment decisions have been made on the basis of the system that is in place there, and to remove it now there will be winners and there will be losers and the main concern is the losers.
THE PRESIDENT: What investment decisions in relation to any of the large non-potable customers have been taken since the introduction of the non-potable tariff in 2003?
MR. ANDERSON: Well I could not answer that, we can certainly investigate if that would assist.
THE PRESIDENT: All these plants have been there for years, well before anybody applied a tariff to them, for these large non-potable industrial customers.
MR. ANDERSON: But they have been there on the basis of a system of pricing which has been moving towards regional averaging since privatisation as much as it could, given the special agreements that have been inherited. It has always been the policy to introduce regional pricing, and that is the position where we now are with a large industrial tariff and now with a new tariff for non-potable users. We have set this out at some length in our Annexes to our original Defence.
THE PRESIDENT: The original Defence, as I remember you explained very carefully and helpfully in the last hearing, was talking largely about the farmer up in the hill and the cottager down in the valley, which is the domestic situation. These are the very large industrial plants that historically were always treated on what one can loosely describe as a "one-off" basis.
MR. ANDERSON: I am not sure that we accept ----
THE PRESIDENT: Well I may be wrong, you put me right. You put me right.

MR. ANDERSON: I will go back and check the position, but I do not accept that the position is that large industrial users who have historically been on a bespoke basis with their water undertakers have suddenly had regional averaging imposed upon them since this case began, and somebody happened to think of it in 2003.

THE PRESIDENT: That is not quite what I meant, but I am only raising these points so that you can deal with them.

MR. ANDERSON: I will.

THE PRESIDENT: Our impression is that in 2003 that was the first time the large industrial non-potable tariff came in. At that time nobody was actually on that tariff. Some people have apparently since migrated to that tariff, but a number have not.

MR. ANDERSON: Well my understanding of it is that subject to the proviso that special agreements have been inherited that do have nuances and idiosyncrasies, special agreements have themselves been based on regional averaging. It is now moving from those regionally average special agreements to large industrial tariffs.

THE PRESIDENT: Well it may be too difficult to go into the detailed history of it all, that I accept.

MR. ANDERSON: Regional averaging has been the basis of pricing subject to the idiosyncrasies of historical special agreement since 1989.

THE PRESIDENT: Is there a tension in your view between the introduction of competition for the large industrial customers, and regional averaging for large industrial customers?

MR. ANDERSON: Is there a tension between competition between – well, it creates on one particular input we would say a level playing field between everyone within that region. I can see in theory an argument for saying that there is a theoretical tension, yes. That is an argument but I am told "no"! (Laughter)

THE PRESIDENT: Jolly good.

MR. ANDERSON: I am told "no" under the costs' principle. Under the costs' principle that any such tension does not exist, and I can see the logic of that because you then have site specific or customer specific avoided costs, and that is what makes the difference.

THE PRESIDENT: But you get different prices for the different customers depending on how much costs you can avoid serving a particular site.

MR. ANDERSON: You might get different prices.

THE PRESIDENT: Unless there is some reason to suppose there is -----

MR. ANDERSON: Access pricing is the input for the access to enable the supplier to be replaced by another supplier which may or may not feed into different prices. It may feed

through into a different level of service. It need not necessarily be a reduction in price – it could be price, it need not necessarily be price.

THE PRESIDENT: What sort of change in service would you have in mind?

MR. ANDERSON: I would need to think about that, Sir, if I may.

THE PRESIDENT: Yes, of course, Mr. Anderson. Yes, I am sorry, we are taking you out of your way, but it is just our attempts to understand these difficult issues.

MR. ANDERSON: I am very, very keen that you do understand our case. Network industry common costs. So there are extensive common costs, we say, that customers share – even customers on dedicated pipes use services which are common to all customers such as leakage, repair, customer service and billing and so on, and these costs have to be covered by an appointed water company and, on losing a customer the appointed company will need to recover the lost contribution to common costs through the access price or by increased charges to other customers.

Water distribution we say is a natural monopoly, that is due to the capital intensive nature of the industry, the high cost of duplicating existing network, the large economies of scale, water distribution exhibits strong natural monopoly characteristics.

THE PRESIDENT: Could I just ask about footnote 15? "Note that increasing charges to other customers is not allowed under the cost principle in the Water Act."

MR. ANDERSON: I will need to ask what is meant by that. I understand entirely where you are coming from, Sir, on that.

Over the page, para.23, natural monopoly part of the water industry is larger than any other network industries because the water distribution costs are higher. According to the European Commission transporting water over 100 kms represents about 50 per cent. of the wholesale cost of water compared to 5 per cent. for electricity and 2.5 per cent. for gas – that is the 'water is heavy' point. For this reason there is no national grid for water distribution as there is for telecoms, gas and electricity on the national grid. There is, we state, less scope for competition in water because the revenue from the potentially competitive activity such as abstraction and retail represent a smaller proportion of total industry revenues than in the case of other network industries.

Then moving on to regulation of the industry, vertically integrated incumbents. "The Government decided that appointed water companies will remain as vertically integrated companies with continuing statutory rights and duties for the whole of the supply chain", and that is a quote from the DEFRA consultation. At the bottom of that paragraph - this is to be contrasted with rail, electricity, and the gas sectors, where there are separate

companies to run the networks, although acknowledge that vertical integration remains in the telecoms' sector. We are not aware of any other major country where water companies have been split into separate activities.

Vertically integrated accounts: since the Government has decided to retain vertically integrated water companies we do not currently require the appointed companies to organise their accounts as if they consisted of independent abstraction, treatment, distribution, retail arms. Instead we have recently focused on appointed water companies calculating and publishing their indicative access prices under the water supply licensing regime, and we would emphasise to you that the documents you have been taken to by Mr. O'Reilly are indicative access prices and the example he took you through is purely illustrative on how to calculate the price. That is made quite clear ----

THE PRESIDENT: But it gives a pretty broad hint, does it not?

MR. ANDERSON: No, we would not accept it does give a hint in any absolute terms. It simply gives an indication of the mechanism. Nature of the product: first, it is expensive to distribute, secondly, there is no scope for product differentiation, limited scope for innovation. "As mentioned above, new telecom entrants can provide …"

THE PRESIDENT: That is just a reference ----

MR. ANDERSON: That is a point we have been discussing.

THE PRESIDENT: NERA?

MR. ANDERSON: Yes. Well, it is a reference to NERA. There is, however, scope for innovation through other means in the water industry. For example, innovation is already being given on price regulations.

THE PRESIDENT: 29, if you take all these points cumulative, would it be a possible inference or not that if all these points are right there are strong arguments really for not having any competition at all, or at least could one infer that Ofwat in its heart of hearts does not really believe in competition in this industry for the reasons set out here?

MR. ANDERSON: No, that would not be fair. Certainly the view of the Directorate General of Competition in the European Union that there is virtually no scope for competition in the water industry, and it says in that newsletter that I refer you to, and we can provide copies to you, that they will sit back with interest and see what happens in England and Wales, but that he does not see scope for competition. No, we have, in pursuance of the statutory duty that had been imposed upon us, sought – and we have made it quite clear with a number of MD documents that have been sent out how seriously we take the duties upon incumbents to have regard to the desire to promote effective competition where appropriate. Certainly we

would look and investigate, and take very seriously suggestions that incumbents were acting in a way that fell outside the scope of their obligations. But, having said that, we do of course recognise that this is a market where the introduction of competition will necessarily have to proceed cautiously, and there may in fact, at the end of the day, be limited actual scope for the number of new entrants that come in. But, there is scope. That is, after all, why we granted the inset appointment in the first place – in the hope that Albion would be able to develop an alternative source, and then be able to supply with a margin. That is not how it has turned out. But, no, it would not be fair to say that in our heart of hearts we do not believe there is any scope for competition, merely that we are realistic about how far that scope can, at the moment, be realised. I do not know if that answers your question.

THE PRESIDENT: That is a helpful answer. Would it be a fair inference that at least between the existing water companies - each of the statutory undertakers – there is at least a tacit situation in which those existing water undertakers do not really compete with each other, in each other's areas?

MR. ANDERSON: I would not accept there is any such tacit understanding ----

THE PRESIDENT: I did not say 'understanding'. I said 'situation'.

MR. ANDERSON: I simply do not know. I mean, I know that undertakers are granted areas, and that is the area, no doubt, in which they will operate. But, quite what the nature of the situation and their borders between particular large customers is concerned, I simply could not answer that.

THE PRESIDENT: I think we have got one example of Severn Trent supplying in another area at the large user tariff of the incumbent in that area. But, with that exception we do not seem to have much interest among the statutory undertakers in competing with each other – as a broad picture.

MR. ANDERSON: We can look at it overnight. There is some cross-border competition, certainly, between regions.

THE PRESIDENT: There were two or three examples, I think, which are in the interim Judgment.

MR. ANDERSON: I am not sure how widespread that is.

PROFESSOR PICKERING: A question on para. 25 on vertically integrated, or not disintegrated accounts: this paragraph presumably refers to the financial accounts. We heard from Mr. Jones that the management accounts are also not vertically disintegrated. Given that, how then is it possible for an incumbent to show that its access price is no higher than it would charge itself for the same service?

MR. ANDERSON: Well, we have sought to explain what we meant in whichever MD number it was about how that is intended to operate in practice. I would need to look up the reference as to precisely how it is that we put it because I would not want to say anything that was different to the way that we put it, because we drafted in carefully. But, the way in which one would do that necessarily involves some element of allocation and assumption. But, in our view – in the government's view – the application of ECPR certainly avoids that problem, to the extent that it ever was a problem.

THE PRESIDENT: But, would you accept that with common carriage, but certainly with the arrival of the 2003 Act which envisages various different activities in distribution activity, treatment activity, or retail activity ---- To make that effective one needs to get rather closer to what the cost of these individual activities actually are than one has at the moment under the existing regulatory system which you do not really need to do that because all the costs are lumped into one big pot.

MR. ANDERSON: We believe that we do have the powers necessary to monitor and observe the costs necessary to apply the costs principle. We do not accept they need to be transparent in the sense that it is available to all – merely that it is sufficient that it can be monitored so that we can at least see whether the access prices that are being charged are appropriate or not. That said, of course, what we are encouraging, and have encouraged, and required the incumbents to do, is to set indicative access charges, and those we can then scrutinise. We believe we have the appropriate powers to secure the information necessary to ensure that those are appropriate indicative access charges.

THE PRESIDENT: But the principle that you do need to know what the costs of abstraction and treatment as distinct from the costs of distribution, as distinct from the costs of retail are in order to make the system work.

MR. ANDERSON: Of the avoidable costs of those activities, yes.

THE PRESIDENT: Why just the avoidable costs? Why not the full cost?

MR. ANDERSON: All that one needs is to deduct the avoidable costs from the retail price.

THE PRESIDENT: But to get to the avoidable costs you have to start with what the costs are and work out what is avoidable, have you not?

MR. ANDERSON: You do not need to understand the amounts of the total costs to quantify the avoidable costs. You merely have to identify what the categories of avoidable costs are and then obtain information to enable that exercise to be undertaken. That does not mean you need to have quantified all the costs. That is what the access guidance document that you were taken to by Mr. Thompson earlier this afternoon was directed at; it was seeking to

identify the types of category of cost that is to be identified as potentially avoidable in the competitive sectors and then seeking from companies some method of quantifying the level of those costs. But that does not in itself require quantitative purposes looking at anything more than the avoidable costs.

THE PRESIDENT: So you do not need to get down to understanding the detailed cost structures in terms of which activity cost what and what the differences in costs are of serving customers of different kinds and different locations and so forth and so on, it can all run perfectly happily without.

MR. ANDERSON: That is de-averaging. You do not need that for the purposes of regulating the retail prices. That is done on a regional average basis. All you need to do is to be able to identify the avoidable costs in any particular situation. For example take this case, it is easy to identify the avoidable costs in this case, you just have to look at what has been avoided by Welsh – that is the resource cost. What is that resource cost, it is the 3p or whatever that they were paying to United Utilities. That is a fairly simple exercise and one can do that exercise without having to enter into any level of granular exploration of underlying costs in any other sector.

THE PRESIDENT: Yes.

MR. ANDERSON: If that is a convenient moment.

THE PRESIDENT: I think it is as convenient as any, thank you, Mr. Anderson. Thank you for your help this afternoon. Now, what time do you want to say tomorrow morning? You gentlemen have other engagements?

MR. THOMPSON: I understand Mr. O'Reilly has a case management conference at 10, I think and I have a Judgment being delivered at 10.

THE PRESIDENT: Is 10.45 inconvenient, or 11 o'clock?

MR. THOMPSON: I am obviously in the Tribunal's hands. I would be grateful for some leeway on it. Ideally I guess it would be 11 o'clock. I have not managed to speak to my instructing solicitors. I have been trying to do so since receiving the Judgment at lunch time.

THE PRESIDENT: You have to get up here from the Strand.

MR. THOMPSON: I see Mr. Vajda standing up.

THE PRESIDENT: Yes, Mr. Vajda? Can you help us, Mr. Vajda?

MR. VAJDA: Well the first thing is I think it is critical that we finish tomorrow.

THE PRESIDENT: Yes, we shall finish tomorrow.

MR. VAJDA: And I do not know how much longer Mr. Anderson is going to be. I said half a day and I will certainly not exceed that. I am very happy if we sit later and finish

tomorrow ----

THE PRESIDENT: We are going to finish tomorrow, do not worry. We might have to sit a bit later, but we cannot avoid the fact that these two gentlemen have other ----

MR. VAJDA: Well, with respect, that is not my understanding of how things normally work. Mr. Thompson has a Junior and these six days have been fixed for a long time, and to put in a case management conference, and say "Well I now want to be released from this case" is not the way – but providing we finish tomorrow that is my main concern, and if the Tribunal is happy to sit late then I am happy to start at 11.

THE PRESIDENT: I think we will sit at 10.45. Thank you.

(Adjourned until 10.45 a.m. on Wednesday, 7th June 2006)