PUBLISHED VERSION

Competition Act 1998

Notice of Decision of the Director General of Water Services

No. CA98/01/2004

Complaint by Albion Water against Dŵr Cymru relating to common carriage for the supply of water to Shotton paper mill

26 May 2004
(Case CA98/00/48)

SUMMARY

The Director General of Water Services ("the Director") received a complaint under the Competition Act 1998 ("CA98") from Albion Water Limited ("Albion Water") against Dŵr Cymru Cyfyngedig ("Dŵr Cymru"). Dŵr Cymru is a statutory water undertaker under the Water Industry Act 1991 ("WIA91"). The complaint related to the terms offered to Albion Water by Dŵr Cymru for access to Dŵr Cymru's water distribution pipes and treatment works used for supplying water to the Shotton paper mill ("Shotton"), a customer of Albion Water. The use of an undertaker's water supply network by a third party in this way is known as "common carriage".

On 1 May 1999, Albion Water became the first new statutory water undertaker since the privatisation of the water industry in England and Wales in 1989. It replaced Dŵr Cymru as the statutory water undertaker in respect of Shotton. It has, since then, purchased water in bulk from Dŵr Cymru at the point of supply to Shotton, which Albion Water then resells to Shotton. Under the current arrangements, Albion Water pays Dŵr Cymru for the water, which Dŵr Cymru purchases from United Utilities Water plc ("United Utilities Water"), as well as such treatment and transportation of that water. Albion Water's complaint under CA98 related to its wish to purchase water from United Utilities Water at the point at which the water is abstracted from the River Dee, and then to pay Dŵr Cymru to transport the water to Shotton through Dŵr Cymru's pipe network and water treatment works.

Albion Water alleged that Dŵr Cymru had breached the prohibition imposed by section 18 CA98 ("the Chapter II Prohibition") for a number of reasons relating to the price it had offered Albion Water for access to its network. In particular, Albion Water alleged that the access price offered by Dŵr Cymru was excessive, amounted to "price squeezing", and was discriminatory.

Albion Water also alleged that Dŵr Cymru had breached the Chapter II Prohibition for a number of other reasons. Albion Water alleged that Dŵr Cymru:

(a) delayed inordinately the agreement of a satisfactory price relating to access;
(b) failed to divulge any information regarding the costs of the system and/or the apportionment of any costs;
(c) failed to negotiate the access price;
(d) began the process of introducing a new standard non-potable tariff which Albion Water alleged would enable Dŵr Cymru to attribute additional costs to the access price;
(e) changed the access price it had originally offered to Albion Water;
(f) engaged in various incidents of misrepresentation;
(g) knowingly and willingly abused its dominance;
(h) limited production, markets or technical developments to the detriment of consumers pursuant to Section 18(2)(b) CA98; and
(i) proposed an access price which Albion Water alleged maintained poor performance of the existing pipe system.

After carrying out an extensive investigation into Albion Water's complaint, we concluded that Dŵr Cymru's access price did contain some cost misallocation. However, we could not conclude that the access price was excessive. In relation to the allegation of "price squeezing", we did not find any evidence that Dŵr Cymru had ceased to incur any retail costs as a result of supplying Albion Water rather than Shotton under the current arrangements, or that Dŵr Cymru would make any similar saving under Albion Water's proposed new common carriage arrangement. In simple terms, under both the current and the proposed new arrangements, in practice, Dŵr Cymru will continue to supply the same water, through the same pipes and treatment works, to the same premises, as it did before the emergence of Albion Water. It will continue to issue one set of bills to one customer. We therefore concluded that there was no evidence of "price squeezing". Finally, we found no evidence that the access price offered by Dŵr Cymru was discriminatory.

In relation to the other aspects of Albion Water's complaint we found no evidence of the alleged abuses.

* Indicates information which is confidential to United Utilities Water and has been excised from the published version of the decision pursuant to section 244(3) of the Enterprise Act 2002.

** Indicates information which is confidential to Dŵr Cymru and has been excised from the published version of the decision pursuant to section 244(3) of the Enterprise Act 2002.

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I. BACKGROUND

A. LEGAL BACKGROUND

Competition Act 1998

1. Under CA98, the Director has, with two exceptions[1], all the powers of the Office of Fair Trading ("OFT") to apply and enforce the provisions of part 1 of CA98 so far as relating to "*commercial activities connected with the supply of water or securing a supply of water or with the provision or securing of sewerage services*"[2] in England and Wales.

2. Section 18(1) CA98 provides that any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom ("UK")[3].

3. Section 18(2) CA98 provides that conduct may, in particular, constitute an abuse if it consists in:

   (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

   (b) limiting production, markets or technical development to the prejudice of consumers;

   (c) *applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;*

   (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.

4. This list is illustrative only and not exhaustive. The European Court of Justice ("ECJ") has held that, "*The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition [...] has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.*"[4]

5. The Chapter II Prohibition came into force on 1 March 2000[5]. It does not have retrospective effect. It therefore applies to abusive conduct which one or more dominant undertakings engage in on, or after, 1 March 2000. Further details of the Chapter II Prohibition can be found

in the OFT Guideline, "The Chapter II Prohibition" (OFT 402, March 1999)[6].

6. Section 60(1) CA98 sets out the principle that, so far as is possible (having regard to any relevant differences between the provisions concerned), questions arising under part 1 of CA98 in relation to competition within the United Kingdom should be dealt with in a manner which is consistent with the treatment of corresponding questions arising in European Community law in relation to competition within the Community. In particular, under Section 60(2) CA98, when determining a question under part 1 of CA98 the Director must act (so far as is compatible with the provisions of part 1 of CA98) with a view to securing that there is no inconsistency between the principles applied, and the decision reached, by him in determining that question, and the principles laid down by the Treaty[7] and the European Court[8], and any relevant decision of the European Court. Under Section 60(3) CA98, the Director must also have regard to any relevant decision or statement of the European Commission[9].

Standard of Proof under CA98

7. In *Napp Pharmaceutical Holdings Limited and Subsidiaries and the Director General of Fair Trading*[10] *("Napp"),* the then Competition Commission Appeal Tribunals[11] ("The Tribunal") discussed the standard of proof in CA98 cases that must be satisfied for an infringement decision to be made. The Tribunal said:

> *"108. Since cases under* [CA98] *involving penalties are serious matters, it follows from Re H*[12] *that strong and convincing evidence will be required before infringements of the Chapter I and Chapter II prohibitions can be found to be proved, even to the civil standard. Indeed, whether we are, in technical terms, applying a civil standard on the basis of strong and convincing evidence, or a criminal standard of beyond reasonable doubt, we think in practice the result is likely to be the same. We find it difficult to imagine, for example, this Tribunal upholding a penalty if there were a reasonable doubt in our minds, or if we were anything less than sure that the decision was soundly based.*
>
> *109. In those circumstances the conclusion we reach is that, formally speaking, the standard of proof in proceedings under* [CA98] *involving penalties is the civil standard of proof, but that standard is to be applied bearing in mind that infringements of* [CA98] *are serious matters attracting severe financial penalties. It is for the Director*[13] *to satisfy us in each case, on the basis of strong and compelling evidence, taking account of the seriousness of what is alleged, that the infringement is duly proved, the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be."*

8. The Tribunal clarified the approach that should be taken when applying the appropriate standard of proof in *Claymore Dairies Limited and*

Express Dairies plc and the Director General of Fair Trading ("Claymore Dairies")[14]. The Tribunal said:

155. […] Under [CA98] *the Director has the functions of both investigation and decision making. Initially, the Director is engaged in a process of investigation. The object of that investigation is to come to a conclusion whether the Chapter II prohibition has been infringed. In the nature of that process, that conclusion can be reached only on the availability of the evidence available. At some stage in the investigation, the Director reaches the point where he considers that he has all the evidence he needs or can usefully obtain. At that stage, he assesses the evidence and makes up his mind. The Director is not, however, an astronomer seeking life on other planets: he is performing a statutory function. In discharging that function, the criteria by which he makes up his mind is not some absolute level of certainty, but the much more prosaic civil standard of proof, albeit applied with due regard to the seriousness of the allegation being made […]. Applying the appropriate standard of proof to the evidence that he has, the Director then makes a decision as to whether the evidence meets that standard. If it does, an infringement has been established to the requisite standard of proof; if it does not, no infringement has been established to the requisite standard of proof on the evidence available."*

Water Industry Act 1991

9. Under section 7 of WIA91, it is the duty of the Secretary of State to secure that at all times there is a company holding an appointment as water undertaker, and a company holding an appointment as sewerage undertaker, for every area of England and Wales. It is possible for the same company to be a sewerage undertaker in relation to the whole or part of the same area in relation to which it is also the water undertaker. Dŵr Cymru is a water and sewerage undertaker, and the area to which its appointment as a water undertaker relates ("Water Supply Area") is slightly different from the area to which its appointment as a sewerage undertaker relates ("Sewerage Area"). The same is true for United Utilities Water.

10. Following privatisation in 1989 the Secretaries of State for the Environment and Wales[15] appointed 10 licensed water and sewerage undertakers and a number of licensed water only undertakers to provide water and sewerage services for England and Wales. The conditions of appointment of each undertaker are set out in the undertaker's Instrument of Appointment ("Licence"), which is enforced by the Director.

11. The Director is the economic regulator of the water and sewerage industries in England and Wales. He is supported by the Office of Water Services ("Ofwat").

12. Amongst other requirements, section 2(2) WIA91 requires the Director to carry out his principal functions in the manner that he considers best calculated to secure that the functions of water and sewerage undertakers are properly carried out, and to secure that undertakers are able to finance the proper carrying out of their functions (in particular, by securing reasonable returns on their capital).

13. Subject to the requirements in section 2(2) WIA91 referred to above, section 2(3) WIA91 requires the Director to carry out his principal functions in the manner that he considers best calculated to, amongst other things:

    (a) ensure that the interests of undertakers' customers are protected as regards the fixing and recovery of charges, and in particular that the interests of customers in rural areas are so protected and that there is no undue preference or undue discrimination in the fixing of those charges (section 2(3)(a) WIA91);

    (b) ensure that the interests of such customers are also protected as respects the other terms on which undertakers provide services, and the quality of those services (section 2(3)(b) WIA91);

    (c) promote economy and efficiency on the part of undertakers (section 2(3)(d) WIA91); and

    (d) facilitate effective competition, with respect to such matters as he considers appropriate, between undertakers or companies seeking to become undertakers (section 2(3)(e) WIA91).

14. Under section 6A WIA91[16] the Director cannot have regard to the above duties ("Section 2 WIA91 Duties") when exercising any of his functions under CA98. Details of the Section 2 WIA91 duties, WIA91 generally, and the relationship between the legal framework for the regulation of undertakers in England and Wales and CA98 are provided in Annexe A of the CA98 Guideline, "The Competition Act 1998 – The Application in the Water and Sewerage Sectors" (OFT 422, February 2000) ("Ofwat Guideline"). The Section 2 WIA91 Duties will be amended by section 39 of the Water Act 2003 ("WA03"), once that section of WA03 comes into force, notably by the inclusion of a duty on the Director (and the Water Services Regulation Authority which will replace him) to carry out his principal functions in the manner that he considers best calculated to further the consumer objective. The Ofwat Guideline does not yet reflect these changes, as it was drafted before WA03 received Royal assent and the relevant provisions in WA03 are not yet in force.

15. Under section 7 WIA91, pursuant to an authorisation from the Secretary of State, in certain circumstances the Director has the power to replace an existing undertaker with another company ("Inset Appointee") as the water and/or sewerage undertaker for a specified

geographical area ("Inset Area"), in a process which results in an "Inset Appointment". These circumstances are set out in sections 7(3) to 7(5) WIA91. As discussed below, Albion Water was granted an Inset Appointment to enable it to supply Shotton in 1999.

16. In practice, an Inset Appointment can be granted in the following three[17] circumstances:

    (a) where all the premises in the Inset Area are each supplied with not less than 100 megalitres[18] ("Ml") or 250Ml (where the area of the relevant incumbent undertaker is wholly or mainly in Wales) of water, in any period of 12 months. This type of Inset Appointment is known as a "Large User Inset Appointment";

    (b) where none of the premises in the Inset Area are served by an existing undertaker (so-called "green-field sites"). This includes areas that may currently be supplied by so-called "private suppliers" which are suppliers of water which are not undertakers regulated under WIA91[19]; and

    (c) where the incumbent undertaker agrees to change the boundary of its Water Supply and/or Sewerage Area to allow all or part of the relevant area to be transferred to another undertaker or potential undertaker.

17. An Inset Appointee becomes a licensed water and/or sewerage undertaker (as appropriate) when the Inset Appointment is granted. As a licensed undertaker, an Inset Appointee must carry out all the functions, and has all the rights and obligations of, any other undertaker under WIA91. These include, for example, complying with environmental and water quality obligations, which are regulated by the Environment Agency ("EA") and the Drinking Water Inspectorate respectively.

18. However, depending on the nature of the Inset Appointment and the Inset Appointee, certain conditions in an Inset Appointee's Licence might be suspended, and only brought into force in certain defined circumstances.

19. A "bulk supply agreement" means an agreement between one or more water undertakers for the supply of water in bulk for distribution by a water undertaker taking the supply[20]. Under sections 40 and 40A WIA91[21], the Director has the power to determine the terms of bulk supply agreements between water undertakers, and between water undertakers and prospective water undertakers, where agreement cannot be reached between the parties. The Director can make a so-called "bulk supply determination" under sections 40 or 40A WIA91, where it appears to him that it is necessary or expedient for the purposes of securing the efficient use of water resources, or the efficient supply of water, that a bulk supply should be made. As

discussed below, Albion Water applied to the Director for a bulk supply determination during its application for an Inset Appointment.

Water Act 2003

20. WA03 received Royal Assent on 20 November 2003. Amongst other things, WIA91 (as amended by WA03) is intended to extend the opportunities for competitive choice in the water industry in England and Wales. Once the relevant provisions have been implemented, customers who consume at least 50Ml per year ("Eligible Customers") will be able to purchase water from water suppliers licensed under the new regime, as an alternative to their incumbent water undertaker.

21. WA03 amends WIA91 by providing a specific framework for new water suppliers to have their water conveyed through distribution networks owned by undertakers to enable the new supplier to supply their customers. In order to do this, the new water suppliers will require a specific licence known as a "Combined Licence". The framework in WIA91 (as amended by WA03) also allows a new supplier to purchase water wholesale from an undertaker at the boundary between the distribution network owned by the undertaker and a customer, to enable the new supplier to supply that customer with the water. The new supplier would require a specific licence (known as a "Retail Licence"). The Government[22] consulted on these proposals.

22. Section 66I(1) WIA91[23] prohibits the use of a water undertaker's supply system for the purpose of supplying water to any premises of a customer, unless the supply is made by the water undertaker itself or by a licensed water supplier in pursuance of a Combined or Retail Licence under the provisions of WIA91 as (amended by WA03)[24]. Under section 17A(8) WIA91, which will be inserted into WIA91 by Schedule 4, paragraph 1 WA03, a relevant undertaker cannot be granted a Combined Licence[25]. However, other companies within an undertaker's wider corporate group will be able to apply for a Combined Licence subject to a new duty imposed on the Water Services Regulation Authority ("Authority"), which will replace the Director, and the Secretary of State that certain powers and duties must be exercised and performed in the manner which they consider is best calculated to, amongst other things, ensure that consumers are also protected as respects any activities carried out by an undertaker which are not attributable to the exercise of functions of the undertaker, or as respects any activities of any person appearing to be connected with the undertaker[26]. In practice, it is expected that this will result in a Combined Licence prohibiting the Combined Licence holder from carrying on any activities in the Water Supply Area of the undertaker with which it is associated[27].

23. Under the new water supply regime, the access price will be calculated under a specific principle (the "Costs Principle" which is discussed later) which under WIA91 (as amended by WA03) undertakers will

have to apply in these circumstances. To the extent that undertakers will be deemed to be engaging in conduct to comply with a legal requirement in doing so, the Chapter II Prohibition will not apply to such conduct[28].

24. It might therefore seem unusual for us to produce a decision under CA98 following a complaint relating to access prices, because whatever the position under CA98, it will be superseded by the relevant provisions of WA03.

25. However, in this case, well before the Queen's speech first referred to the Water Bill in 2002, we had already begun our investigation into Albion Water's complaint and agreed to issue a CA98 decision. In general, however, we would not anticipate carrying out further work on CA98 complaints relating to matters (including access pricing) which will be governed by WIA91 (as amended by WA03), to allow us to focus our resources on the new regime.

B. FACTUAL BACKGROUND

The Parties

Dŵr Cymru

26. Dŵr Cymru (which trades as Dŵr Cymru Welsh Water) is the regulated undertaker that provides water and sewerage services in Wales and some adjoining areas of England. A map showing its Water Supply Area is contained in Annex 2. It has approximately 1.17 million household water customers and 102,000 non-household water customers. It also has approximately 1.22 million household sewerage customers and 75,000 non-household sewerage customers. It provides water services over an area of around 20,400km^2 and sewerage services over an area of around 21,300km^2. Dŵr Cymru is owned by Glas Cymru (Securities) Cyfyngedig which is in turn owned by Glas Cymru Cyfyngedig. Glas Cymru Cyfyngedig is a "not-for-profit" company limited by guarantee which was established for the specific purpose of acquiring and owning Dŵr Cymru. As a company limited by guarantee, Glas Cymru does not pay dividends to shareholders. Any financial surpluses are available to be re-invested in benefits for customers.

27. Under Heads of Agreement between Dŵr Cymru and United Utilities Water dated 10 May 1994 ("First Bulk Supply Agreement"), Dŵr Cymru has purchased water in bulk from United Utilities Water for onward sale to some of its customers. This water is abstracted by United Utilities Water from the River Dee at Heronbridge ("the Heronbridge Abstraction Point"). Until Albion Water was granted an Inset Appointment to supply Shotton, Dŵr Cymru supplied this water to Shotton and a neighbouring site owned by [**][29]. Following Albion Water's Inset Appointment which came into effect on 1 May 1999, Dŵr Cymru continued to supply

this water to [**]. However, as part of a temporary arrangement[30], under a bulk supply agreement between Dŵr Cymru and Albion Water dated 10 March 1999 ("Second Bulk Supply Agreement"), Dŵr Cymru supplied the water for Shotton to Albion Water, at the boundary between Dŵr Cymru's distribution network and Shotton. The Second Bulk Supply Agreement came into force on 1 May 1999 and expired on 1 May 2003. The parties have not yet reached agreement as to the terms of a new bulk supply agreement (although currently Dŵr Cymru is continuing to supply the water to Albion Water as if the Second Bulk Supply Agreement had not expired).

United Utilities Water

28. North West Water Group PLC, which owned North West Water Ltd, acquired the electricity provider NORWEB plc on 8 November 1995. North West Water Group PLC was renamed United Utilities PLC on 1 January 1996, and became the holding company of North West Water Ltd. North West Water Ltd and NORWEB plc were later renamed United Utilities Water PLC, and United Utilities Electricity PLC, respectively. United Utilities Water provides water and sewerage services to customers in North West England. A map showing its Water Supply Area is contained in Annex 2. It has approximately 2.74 million household water customers and 204,000 non-household water customers. It also has approximately 2.72 million household sewerage customers and 174,000 non-household sewerage customers. It provides water services over an area of around 14,415km^2 and sewerage services over an area of around 14,445km^2.

29. United Utilities Water supplies to Dŵr Cymru the water which is ultimately used by Shotton and [**]. United Utilities Water has been in negotiations with Albion Water to supply the water for use by Shotton direct to Albion Water, before that water enters the distribution network owned by Dŵr Cymru.

Dee Valley

30. Dee Valley Group plc is the holding company of Dee Valley Water plc ("Dee Valley"). Dee Valley is a water undertaker, but not a sewerage undertaker. It has approximately 103,000 household water customers and 8,000 non-household water customers. It provides water services over an area of around 831km^2, based around Wrexham and Chester. A map showing its Water Supply Area is contained in Annex 2. Around 85% of Dee Valley's water is extracted from the River Dee with the remainder coming from impounding reservoirs on the Llandegla mountains, boreholes, and natural springs. Dee Valley is not the focus of Albion Water's complaint. However, Dee Valley's Water Supply Area borders on to that of Dŵr Cymru and United Utilities Water and Dee Valley was sent a Section 26 Notice[31] in connection with the complaint. Hence, details of Dee Valley are included here.

Shotton

31. Shotton is a paper mill established in 1985 and based at Weighbridge Road, Shotton, Deeside. It is owned by UPM–Kymmene (UK) Limited ("UPM") (formerly the Shotton Paper Company plc). Shotton produces newsprint and has an annual capacity of around 470,000 tonnes. It uses an average of approximately 18.1 Ml of non-potable water[32] per day in its production process. Shotton is the only customer of Albion Water's regulated business[33] (which equates to approximately 6,600 Ml per year).

Albion Water

32. On 1 May 1999, Albion Water was granted an Inset Appointment and became the first new statutory water undertaker since the privatisation of the water industry in England and Wales in 1989 (existing undertakers have obtained Inset Appointments in other undertakers' Water Supply and Sewerage Areas). Albion Water's Water Supply Area covers Shotton's premises, and thus Albion Water replaced Dŵr Cymru as the water undertaker for Shotton. Maps showing its Water Supply Area are contained in Annexes 2 and 4 (in more detail). At the time, Albion Water was the wholly-owned subsidiary of Enviro-Logic Limited ("Enviro-Logic"). Enviro-Logic was 50% owned by Pennon Group plc ("Pennon") and 50% owned by individuals (including the Managing Director of Albion Water). Pennon is the holding company of South West Water Limited, a water and sewerage undertaker whose Water Supply and Sewerage Areas cover Devon, Cornwall and parts of Dorset and Somerset.

33. Since 6 May 2003, Pennon has owned 100% of the shares in Enviro-Logic. Following Pennon's acquisition of the additional shares in Enviro-Logic, Enviro-Logic was renamed Peninsula Water Limited ("Peninsula Water"). However, as the company was only renamed recently, most of the relevant documents in this case refer to Enviro-Logic, and this decision therefore refers to Enviro-Logic, rather than Peninsula Water, throughout. On 19 February 2004, Waterlevel Limited, a new company set up by the former Managing Director of Albion Water, acquired Albion Water from Pennon.

Background to Albion Water's Inset Appointment

34. As part of Albion Water's Inset Appointment application, Albion Water informed us that it planned to develop an alternative source of water at the Milwr tunnel with which to supply Shotton. The source at the Milwr tunnel has sometimes been referred to as the Halkyn mountain in correspondence. For consistency, this decision refers to the source as the "Milwr Tunnel". The Milwr Tunnel is a tunnel driven between 1897 and 1985 from Boot End near Bagillt on the Flintshire coast, ten miles inland towards the Halkyn mountain. Its purpose was to lower the water table to allow mining work to be carried out at greater depths. It

connected over 65 kilometres of mine workings including a tunnel known as the Halkyn drainage tunnel. The tunnel was transferred to Dŵr Cymru in 1992 and was transferred from Dŵr Cymru to a subsidiary of Dŵr Cymru, Welsh Water Industrial Services ("Welsh Water Industrial"), on 1 April 1993. Welsh Water Industrial was subsequently renamed Hyder Industrial Limited ("Hyder Industrial"). Hyder Industrial was later acquired by United Utilities plc.

35. The development of an alternative source of water was integral to the viability of Albion Water's business plan for Shotton and ultimately the success of the Inset Appointment. As part of its application for an Inset Appointment, on 26 November 1997 Enviro-Logic submitted a business plan and cashflow forecast for the supply of Shotton. The plan covered the period from 1998/99 to 2008/09 and forecast the use of the Milwr Tunnel from the second half of the second year of the date Albion Water was granted an Inset Appointment. A letter from Enviro-Logic to us dated 24 April 1997 stated that, *"*[…] *It is the case, as we have advised you, that our intention is to replace the existing source, for Shotton Paper, with an alternative source once we are established as an inset appointee.* […]".

36. Albion Water was granted its Inset Appointment in May 1999, on the understanding that it would develop and use its own source of water to supply Shotton. Condition O of Albion Water's Licence allows the Secretary of State to terminate the Licence by giving one year's notice, expiring not earlier than five years after 1 May 1999. In a letter of 18 December 1997 to Enviro-Logic, we explained that, *"in practice, the licence will be similar to existing licences, which run indefinitely unless the Secretary of State gives 10 years' notice of termination*[34]*. However, in the light of uncertainty surrounding* [Albion Water's] *ability to acquire a cheaper resource, the Director intends to reduce the minimum licence length and minimum notice period to 5 years and 1 year"*.

37. On 14 July 1998 Allan Merry, then Ofwat's Legal Adviser, repeated this point when writing to Enviro-Logic about the Licence Conditions which would be included in Albion Water's Licence. In the letter he stated, *"Condition O provides for Termination by Notice. We have concluded that the appointment should be terminable on one year's notice, taking effect not earlier than five years from its commencement. This arrangement is intended to accommodate the possibility that the entrant may not, after all, secure access to resources under its control within the timescale currently envisaged"*[35]*.*

38. It was our understanding that Albion Water entered the Second Bulk Supply Agreement with Dŵr Cymru as a temporary arrangement to enable Albion Water to obtain water and have it supplied to Shotton, while Albion Water sought to develop its own water source. We understood that Albion Water planned to terminate the Second Bulk Supply Agreement once it had done so.

39. By 1996 Enviro-Logic had agreed the non-price terms of the Second Bulk Supply Agreement with Dŵr Cymru, but failed to reach agreement on the price. Dŵr Cymru offered a price equivalent to a volumetric rate of 26.16 p/m^3. Albion Water was only prepared to pay 11.92 p/m^3. On 19 June 1996, Enviro-Logic asked the Director to determine the bulk supply price under section 40 WIA91.

40. On 12 December 1996 we provisionally decided that a price of 26p/m^3 would be given to the parties as indicative of the price we would determine formally, if required to do so. In calculating this indicative figure, we had regard to the prices charged by Dŵr Cymru to an associate, Hyder Industrial, for non-potable water (an equivalent of 28.39 p/m^3), the prices charged by Dŵr Cymru to six non-potable large users including Shotton itself (between approximately 26 p/m^3 and 29 p/m^3), and Dŵr Cymru's estimated LRMC (approximately 26p/m^3).

41. In August 1997, Enviro-Logic and Dŵr Cymru agreed a price of 26 p/m^3 for the Second Bulk Supply Agreement without the need for us to make a formal determination under section 40 WIA91[36]. Further details of the Second Bulk Supply Agreement are set out below. In a supply agreement dated 19 March 1999 between Shotton and Albion Water ("Shotton Supply Agreement"), Shotton agreed to pay Albion Water exactly the same price (26 p/m^3) as Albion Water was paying Dŵr Cymru under the Second Bulk Supply Agreement.

42. On 21 March 2001 we wrote to Albion Water asking to be updated on the progress of developing its own source. Albion Water replied on 26 March 2001 explaining that it was keen to make better use of the Milwr Tunnel source both as a possible additional supply to Shotton and to a second customer, Kimberly Clark, at a site in Flint close to the Milwr Tunnel. However, Albion Water stated that its plans had been stalled by Dŵr Cymru's insistence that the Milwr Tunnel had been transferred from Dŵr Cymru to Hyder Industrial, despite evidence to the contrary from the Land Registry and the apparent absence of any notification to us about the asset transfer. Albion Water said Hyder Industrial had refused to allow access to the source.

43. We sought clarification from Dŵr Cymru on this point. On 20 July 1998, Dŵr Cymru explained that the Milwr Tunnel had been transferred to Welsh Water Industrial on 1 April 1993, after which point Dŵr Cymru indicated that it had no right of access to, or any entitlement to possession of, the land transferred to Welsh Water Industrial. Dŵr Cymru indicated that in 1998 Hyder Industrial (formerly Welsh Water Industrial) formally registered its title to the surface land and associated easements relating to the Milwr Tunnel at the Land Registry. Dŵr Cymru explained that registration had been overlooked at the time of transfer and did not come to light until 1997 during the course of litigation.

44. In its letter dated 25 February 2003, Albion Water stated that it had not carried out more detailed studies into the use of the Milwr Tunnel source after it had realised that this source was outside its control. Albion Water maintained on a number of occasions, for example in its letter dated 25 February 2003, that it could not pursue the development of the Milwr Tunnel. (Albion Water's inability to gain access to the Milwr Tunnel did not form part of its CA98 complaint against Dŵr Cymru and we have therefore not considered it in this decision).

45. However, documents provided by Pennon, on 25 February 2003 in response to a Section 26 Notice, indicated that Albion Water considered three separate project plans to make its Inset Appointment profitable, and that it considered the development of a new source to be the least profitable.

46. Albion Water had learned in 1999 that Dŵr Cymru was supplying [**], a customer which neighboured Shotton and which was supplied with the same water through the same pipes, at a price equivalent to [**]p/m^3 [37]. This was a lower price than the 25.8p/m^3 [38] price at which Dŵr Cymru was supplying that water to Albion Water for onward sale to Shotton under the Second Bulk Supply Agreement. The first, and Albion Water considered potentially most profitable[39], option was therefore to seek a formal determination from the Director of the Second Bulk Supply Agreement between Albion Water and Dŵr Cymru under section 40A WIA91, with a view to having the price in the Second Bulk Supply Agreement reduced. Albion Water formally asked for the price to be determined under section 40A WIA91 in a letter dated 12 October 1999. We concluded that there were special circumstances that justified the lower price to [**]. As discussed below, [**] allows Dŵr Cymru to use lagoons owned by [**], which Dŵr Cymru can use as a balancing system. The lower price to [**] reflects the value of these lagoons to Dŵr Cymru. We therefore concluded that a formal determination of the Second Bulk Supply Agreement would not be appropriate.

47. The second, and Albion Water considered potentially next most profitable, option was to obtain the relevant water direct from United Utilities Water under a bulk supply agreement and separately seek a common carriage access price from Dŵr Cymru to treat and transport the water through Dŵr Cymru's distribution network to Shotton. This option ultimately led to Albion Water's CA98 complaint in this case.

48. The third, and Albion Water considered potentially least profitable, option was to develop a new source such as the Milwr Tunnel (which would involve building a new pipeline to link the source to customers' premises).

49. Papers produced by Enviro-Logic for the Pennon Board dated 15 July 1999 state that "*three routes to the achievement of lower bulk supply costs are a new pipeline, common carriage and a re-determination*

based on the [**] *tariff. The last of these is likely to be the most attractive but depends on regulatory decisions that have been described before*. [United Utilities Water's] *enthusiasm for the common carriage approach is welcome but we must ensure that we maximise our gains from any such collaboration. The pipeline option will be retained but not progressed until the other options have been exhausted*."

Background to Abstraction and Supply Arrangements

50. Abstraction is the taking of water from any source, either permanently or temporarily, usually by pumping. Water may be abstracted under water abstraction licences from surface or groundwater sources such as lakes, reservoirs, estuaries, rivers, canals or boreholes[40]. The EA is responsible for the management of water resources in England and Wales. Applications for abstraction licences are made to the EA stating the amount to be abstracted, the point of abstraction and the intended use of the water. The person applying for a licence must also serve notice on the undertaker in whose Water Supply Area the water is to be abstracted. The EA will grant the licence, usually within three months, if it is satisfied with the need for the new abstraction after an analysis of demands and an appropriate environmental assessment.

51. An abstraction licence permits the removal of water from a specified source of supply and generally sets out the conditions of abstraction, such as how much water the licensee can abstract, where it may abstract from and how often it may abstract. It gives the licensee a right to take water from the stated source every year, until the licence expires or until the licence holder wishes to give up that right by cancelling the licence. The licence may also be subject to other conditions such as: what the water can be used for; the land where the water can be used; conditions to protect other interests and the water environment; and the means by which abstraction is measured and records kept. Further restrictions could be included in licences depending on specific local conditions. Most abstraction licences are granted for a limited number of years. At the end of the licence period the licensee must submit a new licence application if it wishes to continue abstracting water.

52. Abstracted water can be supplied in one of three forms: "raw water" (which has not been treated at all), "partially treated water" (which has been partially treated, but is not suitable for drinking), and "potable water" (which has been fully treated, and is suitable for drinking). "Raw water" and "partially treated water" can both be described as "non-potable water".

52. Shotton is supplied with both potable and non-potable water, supplied through separate pipes. In both value and volume, the non-potable supply greatly exceeds the potable supply. In its complaint Albion Water focused purely on Dŵr Cymru's conduct in respect of the non-

potable supply, as we did in our investigation and in this decision. Any references to the relevant supply and/or water in this decision are therefore to the supply of **non-potable** water only, unless otherwise stated.

53. The water used by Shotton is abstracted by United Utilities Water at the Heronbridge Abstraction Point. Dŵr Cymru then purchases the water from United Utilities Water and transports it through a pipe to a treatment works at Ashgrove which is relatively close to the Heronbridge Abstraction Point ("Ashgrove Treatment Works"). The water receives limited treatment by chemically assisted settlement. The water is therefore partially treated water, but it has been generally referred to as non-potable water in correspondence during this investigation. The water is then transported by pipe to Shotton and [**]. The pipe which links the Heronbridge Abstraction Point to Shotton and [**] ("Ashgrove Pipe") and the Ashgrove Treatment Works together form the "Ashgrove System". A map of the Ashgrove System is contained in Annex 3. There are no customers connected to the Ashgrove System other than Shotton and [**].

54. The Shotton and [**] sites are linked by a connecting pipe. At the site of a former water treatment works on the Ashgrove System at Sealand ("the Sealand Treatment Works") a valve (known as a "rotork" valve) divides the water between Shotton and [**]. The water destined for Shotton goes into a storage tank at the Sealand Treatment Works with a capacity of approximately 4.5 Ml. The remaining water goes to [**] where a lagoon system with a total capacity of approximately 29 Ml is available to store the water. The water does not necessarily go through these lagoons to Shotton, but the water in these lagoons is available to Shotton if required. Shotton's demand for water varies considerably. Where Shotton's demand changes and it requires less water, Dŵr Cymru uses the rotork valve to direct the excess water (which was destined for use by Shotton) into the lagoons owned by [**]. It is not possible simply to shut the rotork valve to cease the supply to Shotton. As a result, the lagoons owned by [**] enable Dŵr Cymru to control the flows of water through the Ashgrove System, and in this sense they are used as a "balancing system". The benefit of using this balancing system was one of Dŵr Cymru's reasons for agreeing a price for the supply of water to [**] which was lower than the price of supply charged to Shotton (before Albion Water obtained its Inset Appointment) and the price of supply to Albion Water under the Second Bulk Supply Agreement (following Albion Water's Inset Appointment).

55. United Utilities Water is permitted to abstract water from the Heronbridge Abstraction Point under Licence Number 24/67/9/147/S ("the Heronbridge Abstraction Licence"). The maximum volume of water that can be abstracted from the River Dee at the Heronbridge Abstraction Point under the Heronbridge Abstraction Licence is 236.39Ml per day. This is, however, subject to the following additional restrictions.

56. Under the Heronbridge Abstraction Licence, United Utilities Water may abstract water from two other points on the River Dee in addition to the Heronbridge Abstraction Point. These are at Dee Bridge ("Dee Bridge Abstraction Point") and Huntington ("the Huntington Abstraction Point"). The maximum volume of water that can be abstracted from the River Dee at the Dee Bridge Abstraction Point is 136.38Ml per day. The maximum volume of water that can be abstracted from the River Dee at the Huntington Abstraction Point is 436.4Ml per day. The aggregate maximum permitted abstraction for the Heronbridge Abstraction Point, the Dee Bridge Abstraction Point and the Huntington Abstraction Point is 686.45Ml per day.

57. United Utilities Water may also abstract water from the River Dee at two points at Llangollen under Licence Number 24/67/5/57/S ("the Llangollen Abstraction Licence") up to a maximum of 50Ml per day. However, under the Llangollen Abstraction Licence, the maximum aggregate volume of water that can be abstracted under the Heronbridge Abstraction Licence and the Llangollen Abstraction Licence together is 709.18Ml per day.

58. The Heronbridge Abstraction Licence also specifies that no water can be abstracted when the level of the water in the River Dee immediately above Chester weir is below the level of 13.85 feet above sea level. There may also be additional restrictions imposed by the EA during severe drought conditions.

59. United Utilities Water abstracts the water from the River Dee at the Heronbridge Abstraction Point using a pumping station. There are three pumps that pump water into the Ashgrove System. Only two of these pumps can be run at any one time due to the electrical capacity of the pump control system. This limits the maximum volume that can be pumped into the Ashgrove System to approximately [*]Ml per day. In addition, there are four pumps at the same pumping station that pump water through a pipeline (the "Curzon Park Pipeline") to customers in the Wirral, via United Utilities Water's water treatment works at Sutton Hall ("Sutton Hall Treatment Works"). Together the Curzon Park Pipeline and the Sutton Hall Treatment Works are known as the "Curzon Park System". Only three of these pumps can be run at any one time due to pressure constraints on the Curzon Park Pipeline which limit the maximum pump and Curzon Park Pipeline capacity to approximately [*]Ml per day.

60. Unlike some abstraction licences, the Heronbridge Abstraction Licence does not dictate how the water is to be distributed to the end-customers, or restrict the end-customers to whom the water may be sold. The Heronbridge Abstraction Licence was granted under Section 30 of the Water Resources Act 1963 ("WRA63"). Section 30 WRA63[41] sets out the matters to be specified in licences. For example, a licence under section 30 WRA63 should specify to whom the licence has been

granted; how long it will remain in force; the quantity of water authorised to be abstracted; the method of measurement or assessment of the amount extracted and the means by which the water will be abstracted. An abstraction licence should generally also state the land on which, and the purpose for which, the water is to be used. However, this provision does not apply to licences granted to a water undertaker for the purposes of performing its functions as an undertaker, such as the Heronbridge Abstraction Licence.

61. The average daily volumes of water abstracted at the Heronbridge Abstraction Point are the following:

Period	**Average Volume (Ml per day)**[1]
1 January 1999 – 31 March 1999	[*]
1 April 1999 – 31 March 2000	[*]
1 April 2000 – 31 March 2001	[*]
1 April 2001 – 31 March 2002	[*]
1 April 2002 – 5 August 2002	[*]
Average	[*]

[1]Source: United Utilities Water

62. Of the above average daily volumes abstracted at the Heronbridge Abstraction Point, United Utilities Water supplies the following volumes to Dŵr Cymru under the First Bulk Supply Agreement between the parties, with the remainder of the abstracted water being used by United Utilities Water for its own purposes:

Period	**Average Volume (Ml per day)**[1]
1 January 1999 – 31 March 1999	28.3
1 April 1999 – 31 March 2000	27.2
1 April 2000 – 31 March 2001	26.7
1 April 2001 – 31 March 2002	25.7
1 April 2002 – 5 August 2002	24.6
Average	26.5

[1]Source: United Utilities Water

63. On the basis of these figures, United Utilities Water sells approximately [*]% of the average daily volume of water it abstracts at the Heronbridge Abstraction Point to Dŵr Cymru under the First Bulk Supply Agreement, and uses the remaining [*]% for its own purposes.

64. In a letter to us dated 18 January 2002, United Utilities Water stated that under the First Bulk Supply Agreement, Dŵr Cymru could demand up to 36 Ml per day. However, the First Bulk Supply Agreement provides that Dŵr Cymru can request this to be increased to a maximum of 50 Ml per day if Dŵr Cymru chooses to fund the installation of an additional pump. But, as the table in paragraph 62 indicates, in practice Dŵr Cymru has only required an average of 26.5 Ml per day (in the period from 1 January 1999 to 5 August 2002), which equates to approximately [*]% of the water abstracted at the Heronbridge Abstraction Point. United Utilities Water uses the remaining [*]% for its

own purposes (the water is distributed through the Curzon Park System).

65. Under the First Bulk Supply Agreement, Dŵr Cymru pays United Utilities Water for part of the costs of abstracting the water at the Heronbridge Abstraction Point. Dŵr Cymru pays for direct operating costs associated with its part of the abstraction at the Heronbridge Abstraction Point (i.e. the costs of the Heronbridge Abstraction Licence itself and electricity), and 22% of the fixed operational costs, overheads and financing charges for the intake works at the Heronbridge Abstraction Point. In its letter to us of 13 February 2003, United Utilities Water stated that the fee charged to Dŵr Cymru had historically been broadly equivalent to around 3p/$m^{3.}$ However, this varies depending upon the volume of water taken and the level of any additional capital costs in maintaining the supply. From information published in Ofwat's 2004/2005 Special Agreements' Register, based on the volume of water taken in 2002/2003, this equates to around 3.2p/m^3 for 2002/2003, 4.2p/m^3 for 2003/2004 and the budget assumption for 2004/2005 is 4.3p/m^3. The increase in 2003/2004 reflects a recovery of capital expenditure made by United Utilities Water in maintaining the supply, as does the budget assumption for 2004/2005.

66. Under section 3 and schedule 2 of the Shotton Supply Agreement, Albion Water must supply an average of 18Ml (and by agreement up to a maximum of 22Ml) of non-potable water per day to Shotton. The average daily volumes supplied to Shotton are set out in the table below:

Period	**Volume (Average Ml per day)**
1998/1999	18.9[1]
1999/2000	17[1]
2000/2001	18.1[2]
2001/2002	18.5[2]
Average	18.1

1 Source: Dŵr Cymru
2 Source: Albion Water

67. [**]

C. SUMMARY OF ALBION WATER'S COMPLAINT

68. Albion Water alleged that Dŵr Cymru had breached the Chapter II Prohibition for a large number of reasons. During our investigation, Albion Water sent us a vast amount of correspondence which it considered supported its complaint. Because of the sheer volume of the arguments raised in this correspondence, we have found it extremely difficult to fit all the points made by Albion Water into a coherent set of allegations that the Chapter II Prohibition had been breached. Albion Water raised different issues at different stages of the investigation. Sometimes Albion Water withdrew a particular

ground of its complaint, only to raise the issue again at a later stage (please see paragraphs 362 to 364 below).

69. On at least one occasion Albion Water appeared to change its position on a key issue. As discussed above, Albion Water was granted its Inset Appointment in the expectation that it would develop a new water source, which would involve building a new pipe to link that water source to Shotton. However, as part of its CA98 complaint, in a letter dated 5 July 2001, Albion Water's solicitors[42] stated that, *"Our clients do not consider that there are any physically practical or economically viable alternatives to using common carriage through the Ashgrove System to supply the relevant market, and that the facilities are therefore indispensable."* Nevertheless, during the investigation we received from United Utilities Water copies of e-mail correspondence between Albion Water and United Utilities Water in which Albion Water was exploring building its own pipe *"as a last resort"*. In an e-mail dated 19 December 2001, a representative of United Utilities Water provided an initial view that duplicating Dŵr Cymru's pipes would be potentially viable. Documentary evidence indicates that Albion Water was aware that this might undermine its complaint. In an e-mail from Albion Water to United Utilities dated 6 December 2001, Albion Water stated, *"at this stage the initiative needs to be absolutely confidential, and exploratory […] in the short term, I have to be careful not to undermine our position that the* [Dŵr Cymru] *main is an essential facility".* (Further details of this e-mail exchange are provided in paragraphs 151 to 158 below.)

70. Despite the above, we have attempted to approach Albion Water's complaint in what we think is the most logical order possible. We have summarised our understanding of the various elements of Albion Water's complaint below. Further details of each element of the complaint are set out in the section on "Abuse" (see paragraphs 225 to 408 below).

Brief Chronology of Complaint

71. Albion Water first asked Dŵr Cymru formally for a common carriage access agreement and price on 28 September 2000. In a letter to Dŵr Cymru dated 20 October 2000, Enviro-Logic stated that, *"[…] our assessment, following extensive analysis, indicates that a 7p per m^3* [sic] *is a fair, cost-reflective price for water delivered"*. In a letter to us dated 10 November 2000, Albion Water stated that Dŵr Cymru had calculated an access price but was not prepared to give it to Albion Water until after Dŵr Cymru's Board meeting in mid-December 2000. In a letter to us dated 11 December 2000, Albion Water lodged a formal CA98 complaint, drawing our attention to, amongst other things, Dŵr *Cymru's "[…] persistent failure to negotiate the access price that* [Albion Water] *offered on 20 October or to produce an alternative access price"*.

72. In an e-mail to Ofwat dated 18 January 2001, a representative of Enviro-Logic, Roddy Monroe, indicated that Dŵr Cymru had provided Albion Water with an indicative access price of 20p/m^3 ("Indicative First Access Price"), but that this price was unacceptable to Albion Water. In a letter dated 20 February 2001, Dŵr Cymru informed us that it was minded to charge Albion Water a price of 23.2p/m^3 for the services requested ("First Access Price"). Dŵr Cymru informed Albion Water of the First Access Price on 2 March 2001. This was also unacceptable to Albion Water.

73. During our investigation, we corresponded extensively with Albion Water (as well as Dŵr Cymru, United Utilities Water and Dee Valley). This included sending Section 26 Notices to Dŵr Cymru on 29 June 2001 and 16 August 2002, to United Utilities Water on 16 August 2002 and 20 March 2003, to Enviro-Logic and Pennon on 4 February 2003 and to Dee Valley on 24 March 2003. We also met with representatives of Dŵr Cymru on 17 October 2002 and representatives of Albion Water on 30 July 2002, 10 September 2002 and 5 February 2003. Earlier drafts of this decision were sent to Albion Water on 6 June 2003, and to Dŵr Cymru on 24 July 2003. On 24 October 2003, we wrote to United Utilities Water enclosing extracts from the draft decision relating to United Utilities Water and its business. We sent revised drafts of the decision to Albion Water and Dŵr Cymru on 7 April 2004 and 20 April 2004 respectively. We also sent relevant extracts of the draft decision to United Utilities Water on 10 May 2004.

Price related alleged breaches of the Chapter II Prohibition

Excessive Pricing

74. Albion Water argued throughout its complaint that the First Access Price was excessive and that Dŵr Cymru was making supra-normal profits[43]. The specific allegations Albion Water made about the First Access Price are set out below.

    (a) Unreasonable cost recovery: Albion Water argued in a letter dated 25 January 2001 that the First Access Price was excessive because of the extent to which it exceeded Albion Water's estimate of the direct costs of supply, based on Albion Water's belief that the relevant class of customer should comprise only [**] and Shotton.

    (b) Criticisms of Dŵr Cymru's access price methodology: Albion Water criticised Dŵr Cymru's basic approach of calculating the First Access Price by using revenue figures as a proxy for costs, and working backwards from those figures to calculate the individual elements which went to make up the First Access Price. In a letter to us dated 8 March 2001, Enviro-Logic stated that, *"in the short run it is unreasonable to assume that current income is entirely representative of current network costs"*.

Albion Water also challenged the detailed steps Dŵr Cymru had taken when calculating the First Access Price. These criticisms are discussed in more detail below.

(c) Inconsistency with Regulatory Accounting Guidelines ("RAGs"): In Albion Water's view, Dŵr Cymru's calculation of the First Access Price was inconsistent with our Regulatory Accounting Guidelines.

Price Squeezing

75. In its letter to us dated 12 August 2003, Albion Water argued that, *"You are aware that Dŵr Cymru has not only allocated downstream costs (e.g. customer facing costs) to its upstream activities, it has also allocated costs of potable water transportation which are not relevant to the downstream market for the sale of non-potable water, neither to the upstream market. We find it difficult to imagine a clearer example of margin squeeze […]"*.

Discrimination

76. Albion Water also alleged that Dŵr Cymru had engaged in discriminatory conduct for the following reasons.

(a) Albion Water alleged that there were faults in Dŵr Cymru's calculation of the First Access Price. For example, in its letter to us dated 14 May 2002 Albion Water argued that *"[…] Dŵr Cymru insist on basing their charges on potable distribution costs rather than the costs of distributing non-potable water. We contend that the difference in costs between these two is considerable and that the use of potable costs for a non-potable delivery service is both discriminatory and anti-competitive"*.

(b) Albion Water said that Dŵr Cymru's approach to the First Access Price was inconsistent with an open letter from us to Managing Directors of all water undertakers dated 30 June 2000 ("MD 163") about "Pricing Issues for Common Carriage" in which we stated that a company should charge new entrants as it would charge itself.

(c) Albion Water argued that Dŵr Cymru had allegedly based the calculation of the First Access Price on an unrepresentative class of customer. However, in its letter to us dated 14 May 2002, Albion Water withdrew this particular part of its complaint.

(d) In a letter to us dated 5 July 2001, Albion Water argued that, *"the* [First Access Price] *proposed by Dŵr Cymru may potentially apply dissimilar conditions to equivalent transactions with other trading parties. It is significantly higher than prices offered*

> *during April and May 1997 by Dŵr Cymru's then sister company,* [Hyder Industrial]*, for a similar supply to a proposed new customer in the vicinity"*.

Non-price related alleged breaches of the Chapter II Prohibition

Delay

77. Albion Water argued consistently throughout our investigation that Dŵr Cymru was guilty of *"extreme delay in putting forward a fully transparent and fair access price"*[44] and that the *"inordinate delay in achieving a satisfactory offer"*[45] was a breach of the Chapter II Prohibition.

Failure to provide information

78. In a number of Albion Water's letters to us, it complained that Dŵr Cymru's *"refusal to divulge any information regarding the costs of the* [Ashgrove System] *and/or the apportionment of any costs"*[46] was an abuse within the meaning of the Chapter II Prohibition.

Failure to negotiate

79. Similarly, Albion Water complained about what it considered to be Dŵr Cymru's *"persistent failure to negotiate the access price which Albion offered on 20 October […]"*[47]. (Albion Water had offered to pay 7p/m^3.)

Changing tariffs in order to attribute additional costs to the access price

80. Albion Water argued on a number of occasions that Dŵr Cymru had begun the process of introducing a new standard non-potable tariff. Albion Water alleged that this would enable Dŵr Cymru to attribute additional costs to the access price, and thus increase the access price, in breach of the Chapter II Prohibition.

Changing the Indicative First Access Price

81. Albion Water also complained that Dŵr Cymru had initially offered an Indicative First Access Price of 20p/m^3 but had later increased this to 23.2p/m^3. Albion Water alleged that, *"Dŵr Cymru were taking full advantage of delays that they have introduced into the process to manipulate the figures and to produced* [sic] *an artificially high access price"*[48]. Albion Water also considered the increase in prices to be *"further evidence of anti-competitive behaviour, in that the* [Indicative First Access Price] *was deliberately misleading*"[49]. Albion Water also alleged that Dŵr Cymru had misrepresented the fact that the Indicative First Access Price had received Board approval.

Misrepresentation

82. Throughout our investigation, Albion Water complained about various alleged incidents of misrepresentation, *or "possible misrepresentation"*[50], by Dŵr Cymru. In particular, Albion Water alleged in a letter dated 5 July 2001 that Dŵr Cymru had misrepresented its costs in connection with negotiating the access charge and the fact that it had been in discussions with us about its intention to take all non-potable supplies out of so-called "special agreements" and put them on a new non-potable tariff.

Intentional abuse

83. Albion Water alleged that Dŵr Cymru had *"knowingly and willingly"*[51] abused its dominant position in breach of CA98.

Inefficiency

84. In a letter from Albion Water's solicitors dated 5 July 2001, Albion Water stated that, *"we consider that the effect of the access price proposed by Dŵr Cymru is that it maintains the status quo, which features poor performance of the existing system* [i.e. the Ashgrove System] *and inadequate maintenance. There is a real threat of system under performance that would severely damage the viability of our client's existing customer's* [i.e. Shotton's] *business, with a potentially devastating effect on employment in the area. It also prevents Albion Water from offering improved terms to its existing customer and to* [**].

Limiting production, markets or technical developments to the detriment of consumers pursuant to Section 18(2)(b) CA98

85. There are references to section 18(2)(b) CA98 in letters from Albion Water dated 11 December 2000 and 8 March 2001. It is not, however, clear from this correspondence how Albion Water believed Dŵr Cymru was in breach of this sub-section.

II. LEGAL AND ECONOMIC ASSESSMENT

A. RELEVANT MARKET

Introduction

86. For the purposes of competition law, the relevant market can be said to comprise a relevant product and geographic market. The product and geographic markets have been defined by the Commission in its Notice on the definition of the relevant market for the purposes of Community competition law ("Market Definition Notice")[52]. The definitions reflect the case law of the European Court as follows: *"a relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended*

use. The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas."

87. The European Commission has provided guidance on how it applies this concept in practice in the Market Definition Notice. The Market Definition Notice also describes the sorts of information that may be used to define markets. These include product characteristics, evidence of past substitution, differences in prices and price trends, and the views of customers and competitors. Supply-side substitution may also be relevant to a definition of the relevant market where its effects are equivalent to those of demand substitution in terms of effectiveness and immediacy.

Product/Service Market

88. Albion Water indicated that the relevant market for the purpose of its complaint was the market for the transportation of non-potable water for supply to industrial customers in the geographical area served by the Ashgrove System[53].

89. As explained above, non-potable water is water which is not suitable for drinking. Non-potable water can be water which is either raw (i.e. completely untreated) or treated to a certain degree but which is still not suitable for drinking (partially treated water). In addition to non-potable water, water undertakers can supply potable water (i.e. water that is suitable for drinking). Within each type of water, there may be different grades of water. For example, some industrial customers require water which is treated to an even higher standard than potable water. In some cases it might, therefore, be necessary to define the product market by reference to water within certain technical parameters (for example, water which does not exceed a defined amount of a particular substance or element per unit of volume).

90. With regard to the service element of the relevant market, Albion Water has maintained that the service is the transportation of non-potable water (i.e. partially treated water). Albion Water has, on a number of occasions during our investigation, stated that the water leaving the Ashgrove Treatment Works is not of a suitable quality for Shotton's requirements. Further, Albion Water indicated in a letter dated 25 February 2003 that it had offered to construct new water treatment works on site at Shotton. Albion Water stated that this was intended to improve on the quality of water produced at the Ashgrove Treatment Works rather than to replace the Ashgrove Treatment Works. It is clear, therefore, that Shotton requires water which has been treated to some degree (i.e. not raw water).

91. In a letter to us dated 9 September 2002, Albion Water indicated that it considered the Ashgrove Treatment Works to be an 'essential facility' *"in that it provides hydraulic continuity (i.e. a channel or channels) linking the pumping main from Heronbridge to the gravity main to Shotton. To this extent it can be considered part of the conveyance system and short-circuiting these channels for part of the current flow would be operationally impractical"*. Albion Water reiterated this in its letter to us dated 12 August 2003.

92. In light of the above, it appears that Albion Water considered that this aspect of market definition should include the treatment of the relevant water to the standard carried out by the Ashgrove Treatment Works and that the Ashgrove Treatment Works formed part of the alleged 'essential facility'.

93. A detailed assessment of the service element of the market definition might have involved, for example, assessing whether there were separate markets for the transportation of the relevant water and for the treatment of that water. However, we were prepared to accept as a starting point that the relevant product/service market is that for the transportation and partial treatment of water. In light of our conclusions in paragraphs 371 and 408 below, ultimately we have not found it necessary to carry out a more detailed analysis of the relevant product/service market, or to reach a final view of this product/service market in this instance.

Geographic Market

94. In their letter dated 5 July 2001, Albion Water's solicitors stated that it was necessary to consider *"the market where the relevant facility operates (as opposed to the related market where our clients seek to compete, that of actually supplying the two industrial customers at the site* [i.e. Shotton and [**]]*)."*

95. Albion Water's solicitors suggested that the *"market should be defined narrowly, as the market for the transportation of non-potable water for supply to industrial customers in the geographical area served by the Ashgrove System. The industrial customers in question are* [**] *and* [Shotton]*".*

96. The definition of the relevant geographic market advanced by Albion Water is extremely narrow as it assumes that the market is that for the partial treatment of water (presumably water abstracted under the Heronbridge Abstraction Licence) and transportation of that water to Shotton and [**]. In other words, it assumes that the market is that for the treatment and distribution of water abstracted from one point (the Heronbridge Abstraction Point), treated at one point (the Ashgrove Treatment Works) to one standard, distributed through one set of pipes (the Ashgrove System), to the only two customers (Shotton and [**]) connected to those particular pipes.

97. It should be noted that this definition of the relevant geographic market makes the following assumptions. First, it assumes that the market definition should not be widened to include the transportation and treatment of this water to customers other than Shotton and [**]. We have evidence that there are a number of potential industrial customers within the vicinity of Shotton and [**] and within the vicinity of the Heronbridge Abstraction Point. It might therefore be possible for Albion Water to supply such customers using either the Ashgrove System and/or infrastructure other than the Ashgrove System (for example, by constructing new infrastructure or using infrastructure of other undertakers, such as United Utilities Water).

98. Second, it assumes that the market definition should not be widened to include infrastructure other than the Ashgrove System. However, the geographic area in which the Ashgrove System and Shotton are situated is unusual in that there are three water undertakers (other than Albion Water) whose Water Supply Areas are all within close proximity. It is therefore possible that United Utilities Water, Dŵr Cymru or Dee Valley might own infrastructure which could be used to treat and transport the water to Shotton, either from the Heronbridge Abstraction Point or from an alternative source which would result in the geographic market potentially being wider than that advanced by Albion Water.

99. Finally, it assumes that the market definition should not be widened to the market for the transportation and partial treatment of water abstracted from points other than the Heronbridge Abstraction Point for supply to other customers within the relevant area. In this context, the relevant area might be as wide as, for example, the relevant water resource zone[54]. The potential impact of widening the market definition in this respect might be to render access to the Ashgrove System unnecessary (particularly if, for example, water could be abstracted from boreholes near customers). It has been noted above that, at the time of Albion Water's Inset Appointment, it was intended that Albion Water would develop an alternative source.

100. However, although the definition of the relevant market may in fact be wider than that put forward by Albion Water, in light of our conclusions in this decision ultimately we have not found it necessary to carry out a more detailed analysis of the relevant geographic market, or to reach a final view of this geographic market in this instance.

Summary of Market Definition

101. Subject to the above observations, we have been prepared to start our analysis of this case on the basis that the market on which Albion Water alleges Dŵr Cymru is dominant is that for the transportation via the Ashgrove System and partial treatment of water abstracted from the Heronbridge Abstraction Point to Shotton and [**]. In light of our

conclusions in this decision, ultimately we have not found it necessary to carry out a more detailed analysis of the relevant market, or to reach a final view of this market in this instance. It should be noted that the definition of the relevant market proposed by Albion Water is the most advantageous definition from Albion Water's point of view.

B. DOMINANCE AND "ESSENTIAL FACILITIES"

Introduction

102. The European Court of Justice ("ECJ") has defined a dominant market position as:

"…a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers."[55]

103. In assessing whether there is dominance, we consider whether, and to what extent, an undertaking will face constraints on its ability to behave independently. Paragraph 3.11 of the OFT Guideline, "The Chapter II Prohibition" (OFT 402, March 1999) indicates that these constraints might be:

"• *existing competitors, according to their strength in the market: this may be shown by market shares;*

- *potential competitors: this may be shown by a lack of significant entry barriers and the existence of other undertakings which might easily enter the market; and*

- *other constraints such as strong buyer-power from the undertaking's customers (which may include distributors, processors, and commercial users)."*

Albion Water's Arguments

104. Albion Water's views on market definition, dominance and 'essential facilities' are set out in a letter from its solicitors dated 5 July 2001. This letter stated that:

"1. Our clients consider the Ashgrove system is an "essential facility" in the market for the transportation of non-potable water for supply to industrial customers in the geographical area served by the Ashgrove system and that Dŵr Cymru, as the owner of the Ashgrove system, is dominant within the meaning of [CA98]*."*

105. The letter explains that the industrial customers in question are [**] and Shotton. The letter explains also that Albion Water's reasoning for this market definition is as follows:

> "5. *We consider that it is not appropriate to consider any different product market or any wider geographical market than that which we have identified above, because no other facilities compete in the same relevant market and there are no physically practical or economically viable alternative sources of supply for companies seeking to compete at the point of supply for the business of customers at the site, whether in terms of products, due to the basic nature of demand for the product, or geographic location of suppliers, due to the barriers and costs associated with switching demand to potential substitute suppliers."*

106. The letter indicates that Albion Water considered two potential alternative options for transporting water to Shotton other than through the Ashgrove System.

107. The first option was the possible construction of a new pipeline which would enable Albion Water to obtain bulk supplies from an identified alternative source (the Milwr Tunnel) and to transport the water to Shotton. For the reasons set out below, we have not considered in detail the economic viability of this option.

108. The second alternative option was the construction of a duplicate, parallel pipeline running from the Heronbridge Abstraction Point to Shotton. Albion Water estimated the costs of pursuing this option to be "*in the region of £6.5 million*". Albion Water estimated £4.5 million for a settlement facility similar to the Ashgrove Treatment Works and over £2 million for the pipeline. It indicated that these estimates were based on "Ofwat statistics", although it did not state the origin of these Ofwat statistics.

109. Albion Water did not consider this second option to be a viable alternative. In their letter dated 5 July 2001 Albion Water's solicitors stated:

> *"13. This alternative should also be discounted on grounds of cost, environmental disruption and practicality. As regards the economic viability of this option, we would draw your attention to the evidence provided to Ofwat by Dŵr Cymru in July 1996 (Bulk Supply Application by Albion Water) in which they costed a proposal to supply a major new development with an average of 18Ml per day of untreated water, quoting a price to customer of 35p/m³ delivered. In the same evidence they estimated that the costs of replicating the facilities to which access is sought would also lead to a unit price of 35p/m³. These prices are far in excess of the current price to either customer on the network served by the facilities. The use of pipe laying and compulsory purchase powers in order to effect the*

> *delivery of the pipeline is likely to be subject to challenge by land owners and other third parties, who would object to what they would see as unnecessary disruption. Our clients believe that they would also face significant practical difficulties and/or legal constraints, in as much as abstraction from the River Dee is at its limits and the exclusive rights are owned by* [United Utilities Water] *and exercised for the exclusive benefit of Dŵr Cymru. We would submit that this alternative must therefore be discounted."*

110. As mentioned in paragraph 91 above, Albion Water indicated in letters dated 9 September 2002 and 12 August 2003 that it considered the Ashgrove Treatment Works to be an 'essential facility' because it was integral to the Ashgrove System and it would be impractical to bypass it.

Market Shares

111. As mentioned above, we have been prepared to start our analysis of this case on the basis of the extremely narrow market definition put forward by Albion Water, although we do have doubts about whether such a narrow market definition is appropriate. On the basis of this very narrow market definition Dŵr Cymru would have a 100% share of the relevant market.

112. Although market share is an important factor in assessing whether a company holds a dominant position, it is not the only factor that must be considered (particularly where an extremely narrow market definition advanced by a complainant is used as a starting point). The nature of actual and potential competition, and the extent to which this constrains the potentially dominant company, must also be examined. In this case, we considered that potential competition was a key issue to be assessed.

Potential Competitors

Introduction

113. We have seen evidence (in the form of external and internal reports, and e-mail correspondence) that Albion Water and United Utilities Water have considered the possibility of supplying Shotton through the construction of new infrastructure. United Utilities Water owns the Heronbridge Abstraction Licence and the pumps at the Heronbridge Abstraction Point. As such, it has access to the necessary water to supply Shotton as well as the ability to abstract and put sufficient water into the Ashgrove System, or a new system to supply Shotton.

114. It appears that United Utilities Water considered this option in a memo from Ken Hickman to K McKenzie (dated 10 October 1997) entitled "Enviro-Logic Water Supply to Shotton". United Utilities Water provided a copy of a report dated January 1998 carried out by external

consultants (Bechtel Water Technology Estimating Department) (the "Bechtel Report"), which looked into the possible costs of constructing new infrastructure. The Bechtel Report demonstrates that United Utilities Water was, at least in principle, open to the idea of constructing new infrastructure to supply Shotton.

115. United Utilities Water also provided documentation demonstrating that it had, around the time of Albion Water's Inset Appointment, been investigating alternative options for supplying water to Shotton, and had made an approach to Shotton. United Utilities Water provided us with a report carried out by Oxford Economic Research Associates dated 23 August 1999 (the "Oxera Report"). This set out a variety of potential options for supplying Shotton. Some of these involved the construction of additional infrastructure (the "Engineering Solution"). (Other options were based on the existing infrastructure and the intention that either United Utilities Water or Albion Water would pay Dŵr Cymru a 'use-of-system' charge for common carriage. These are referred to as the "Tariff Solution" in this decision.)

116. United Utilities Water has also provided us with a report by Tina Boulton (draft 3) dated 2 September (no year given) entitled "Shotton Paper" (the "Boulton Report"). The Boulton Report appears to be based on the Oxera Report and also sets out details of the possible Engineering Solutions and Tariff Solutions, before recommending Tariff Solutions as the lowest risk solution.

117. It is clear from the e-mail correspondence between United Utilities Water and Albion Water in December 2001 that United Utilities Water was, at least in principle, interested in the prospect of working together with Albion Water to construct new infrastructure to serve Shotton, and that United Utilities Water's initial view was that this would be economically viable.

118. The following paragraphs consider the extent to which Albion Water and United Utilities Water represent a constraint on Dŵr Cymru's ability to behave independently in light of the above Reports and correspondence and the conclusions of our own assessment of the economic viability of either Albion Water or United Utilities Water constructing a duplicate pipe and water treatment works to supply Shotton.

119. It is also possible that there are other potential entrants who may be willing and in a position to supply Shotton. Given the fact that it is likely that any such potential competitors would be similar in nature and financial standing either to Albion Water or United Utilities Water, for example an established water company or a discrete inset appointee, we have not considered it necessary to identify and assess other potential competitors in detail.

Barriers to entry

120. When considering whether a potential competitor represents a constraint on Dŵr Cymru's ability to behave independently, it is necessary to consider whether any barriers to entry exist. Paragraph 5.3 of the OFT Guideline, "Assessment of Market Power" (OFT 415, September 1999) states:

"There are many ways in which different types of entry barrier can be classified, but it is useful to distinguish between three sources:

- *absolute advantages;*
- *strategic advantages; and*
- *exclusionary behaviour [...]"*

Absolute Advantages

121. In some markets an incumbent owns or has access to important assets or resources which are not accessible to the potential entrant. This bestows an absolute advantage on the incumbent so that the new entrant cannot gain access to an asset or resource at any cost or only at a cost substantially higher than that of the incumbent[56].

122. In this case, potential absolute advantages enjoyed by Dŵr Cymru may relate to the ability to lay the necessary pipes or abstract the necessary water to supply Shotton. We have therefore considered whether Dŵr Cymru has such absolute advantages, preventing Albion Water or United Utilities Water from entering the market.

Pipe laying powers

123. Albion Water maintained that, in constructing a duplicate pipeline, it would be subject to challenges from land-owners and other third parties, who would object to what they would see as unnecessary disruption created by a duplicate pipeline.

124. WIA91 contains provisions giving water undertakers powers to lay pipes on private land. Sections 158 and 159 WIA91 contain the basic powers for water undertakers to lay "relevant pipes" in streets and in other land respectively. "Relevant pipe" is defined in section 158(7) in relation to a water undertaker as "*a water main (including a trunk main), resource main, discharge pipe or service pipe."*

125. Section 158(9) WIA91 provides that any pipe intended to supply a "large-user's" premises which is installed by a "large-user" Inset Appointee will be deemed to be a water main. As Albion Water supplies Shotton as part of its Inset Appointment, any pipe laid by Albion Water will be deemed to be a main and will therefore fall within the definition of "relevant pipe."

126. Section 192(3) WIA91 provides that the powers granted by sections 158 and 159 WIA91 are exercisable both inside and outside the relevant undertaker's Water Supply Area. Consequently, Albion Water would have the power to lay pipes in streets and/or other land, either inside or outside its Water Supply Area.

127. Section 192(3A) provides that in certain circumstances a water undertaker seeking to lay relevant pipes outside its Water Supply Area (in land other than streets) must give notice to the water undertaker through whose Water Supply Area the new pipes will pass, and obtain its consent to the proposal or, where that undertaker refuses to consent or fails to do so within 28 days, the Director's consent.

128. However, section 192(3B) WIA91 provides that no such consent is needed where the new pipe is a water main which will be used solely for the purposes of supplying water other than for domestic purposes. Section 218 WIA91 states that any references to domestic purposes in relation to a supply of water to any premises are references to the *"drinking, washing, cooking, central heating and sanitary purposes for which water supplied to those premises may be used."* Assuming that any new pipe Albion Water laid would be used solely for the purposes of supplying non-potable water, the pipe would therefore be used solely for supplying water other than for domestic purposes.

129. There is a strong argument that any pipe which is deemed to be a "main" for the purposes of sections 158 and 159 WIA91 (by the operation of section 158(9) WIA91) should also be deemed to be a main for the purposes of section 192(3B) WIA91. On this basis, Albion Water would not need to obtain the consent of the relevant undertaker before laying a relevant pipe outside its Water Supply Area.

130. Section 159(4) WIA91 provides that the power to lay pipes may only be exercised after reasonable notice has been given to the owner and occupier of the land where the pipe is to be laid. Under section 159(5)(a) WIA91 the minimum period that is capable of constituting reasonable notice is 3 months in cases where the relevant pipe does not replace an existing pipe.

131. Albion Water therefore has the necessary statutory pipe laying powers to lay a new pipe from the Heronbridge Abstraction Point to Shotton. Such powers are exercisable by Albion Water without the need to obtain consent of the relevant landowners (although under sections 159(4) and 159(5)(a) WIA91 Albion Water would have to provide relevant landowners with three months' notice before laying any new pipe under their land). This period can be reduced by agreement. Similarly, United Utilities Water would, as a statutory water undertaker, also have similar pipe laying powers to Albion Water.

132. We have therefore concluded that if either Albion Water, or United Utilities Water, were to construct a new pipe from the Heronbridge

Abstraction Point to Shotton, they would be able to use statutory pipe laying powers to do so.

Abstraction rights

133. In their letter of 5 July 2001, Albion Water's solicitors argued that Albion Water *"would also face significant practical difficulties and/or legal constraints, in as much as abstraction from the River Dee is at its limits and the exclusive rights are owned by* [United Utilities Water] *and exercised for the exclusive benefit of Dŵr Cymru."* This statement implies that Albion Water would be unable to obtain a supply of water originating either from the Heronbridge Abstraction Point or from an appropriate alternative water source for supply to Shotton.

134. However, Albion Water has stated that it has been in negotiations with United Utilities Water to purchase water at the Heronbridge Abstraction Point. Consequently, Albion Water has been taking steps to overcome the "*significant practical difficulties*" it claimed it would face and, if negotiations with United Utilities Water were successful, Albion Water would have access to the water it needed to supply Shotton.

135. However, if Albion Water was unable to obtain a supply of water as its solicitors' letter of 5 July indicates, this appears to contradict a key assumption in Albion Water's complaint against Dŵr Cymru. If Albion Water had no reasonable prospect of obtaining access to the water it required to supply Shotton, then a common carriage agreement with Dŵr Cymru would be pointless (and presumably Albion Water would not have brought the present complaint against Dŵr Cymru under CA98). In this regard, we note that paragraph 140 of Albion Water's Notice of Application to Appeal ("Notice of Appeal") to the Tribunal dated 1 April 2004 (which relates to case 1031/2/4/04, details of which are available on the Tribunal's website) states the following:

"Ofwat has assumed a bulk supply price of 3p/m^3 but was aware from Albion Water's correspondence with United Utilities [Water] *that it had been unable to agree such a price and that United Utilities* [Water] *were seeking a figure over 4 times that price. On 8 February 2001 United Utilities* [Water] *agreed to sell water at 9p/m^3 rather than the price of 12.1p which they sought, but only if Albion Water signed up immediately* […]. *Albion Water refused to do so, believing such action to be itself anti-competitive and in breach of section 18(2)(c) of the Act".*

We understand from Albion Water that this statement was not intended to represent a formal complaint under CA98 against United Utilities Water and that Albion Water is continuing to pursue negotiations with United Utilities Water. This is indicated in its letter of 6 May 2004 to United Utilities Water. We have not, however, investigated the current state of negotiations between Albion Water and United Utilities Water.

At this stage, we have therefore assumed that Albion Water does in fact have a reasonable prospect of obtaining access to the necessary water.

136. In the Section 26 Notice to United Utilities Water of 16 August 2002, we asked United Utilities Water whether it would be able to supply water to Albion Water. In its response dated 29 August 2002, United Utilities Water replied that it could, and/or would, be prepared to supply the whole or part of the water requested by Albion Water.

137. Finally, in the letter dated 5 July 2001 from its solicitors, Albion Water maintained that the *"exclusive rights"* to abstract water from the River Dee were owned by United Utilities Water, and these rights were exercised for the "*exclusive benefit of Dŵr Cymru*". This does not appear to be correct. First, it is not only United Utilities Water which has rights to abstract water from the River Dee. There are a number of abstractors, large and small, who are licensed to abstract water from the River Dee including (but not limited to) United Utilities Water, Dŵr Cymru and Dee Valley. Indeed, we find it difficult to believe that any one company would own all the abstraction licences to abstract water from the River Dee, and no new abstraction licences would be granted to any other company, such that that one company could be said to have "exclusive rights" to abstract water from the River Dee. Second, the abstraction licences owned by United Utilities Water are not exercised exclusively for the benefit of Dŵr Cymru. As discussed in paragraph 63 above, United Utilities Water uses approximately [*]% of the water it abstracts at the Heronbridge Abstraction Point for its own purposes.

138. In light of the above, we do not consider Dŵr Cymru benefits from any absolute advantages preventing Albion Water (or United Utilities Water) from entering the market.

Strategic Advantages

139. The second source of entry barriers arises when a company gains an advantage from being in the market first (sometimes referred to as a 'first-mover advantage'). This type of entry barrier gives an incumbent 'strategic advantages' over any potential new entrant.

140. When a company contemplates entering a market, it weighs up its expected revenue from entering against the expected costs of entering and exiting the market (which may be necessary if entry is unsuccessful). We have therefore considered the likely costs Albion Water or United Utilities Water (or any other potential entrant) would face if they were to construct the infrastructure necessary to supply Shotton compared to the likely revenues from entering the market in this way. Some of these issues are also relevant to an assessment of whether or not the Ashgrove System is an essential facility (which is discussed later in this decision).

141. Similarly, in this context, we have considered whether there are any physical or time constraints which would prevent Albion Water, United Utilities Water or anyone else from entering the market.

Cost of duplication

142. In their letter of 5 July 2001, Albion Water's solicitors stated that, *"Our clients do not consider that there are any physically practical or economically viable alternatives to using common carriage through the Ashgrove System to supply the relevant market, and that the facilities are therefore indispensable."*

143. In the Section 26 Notice of 4 February 2003 Albion Water was asked to specify any possible ways of supplying water to Shotton, otherwise than through the Ashgrove System (either using the Heronbridge Abstraction Point or an alternative source of water). In its letter to us dated 25 February 2003, Albion Water stated that, "*transporting water from Heronbridge to Shotton without the use of the Ashgrove pipeline would be prohibitively expensive compared to the depreciated asset currently used."* It went on to say "*none of the options considered are commercially practicable alternatives to the current supply to Shotton Paper…".*

144. However, the Reports discussed below do not appear to go as far as concluding that duplicating the Ashgrove System would be economically unviable (even if it is the least commercially attractive option). An e-mail exchange between Albion Water and United Utilities Water also indicates that United Utilities Water's initial view was that duplicating the Ashgrove System might be viable, even though Albion Water saw this option as a "*last resort*"[57].

145. The Bechtel Report (dated January 1998) looked into the possible costs of the Engineering Solutions for supplying Shotton, but did not come to any conclusions on viability or recommend a particular solution. United Utilities Water has stressed that this was a desk-top study. However, it demonstrates that United Utilities Water was, at least in principle, open to the idea of constructing new infrastructure to supply Shotton.

146. The Oxera Report (dated 23 August 1999) also set out a variety of potential options for supplying Shotton. The Boulton Report appears to be a report by a United Utilities Water employee which sets out details of the possible Engineering Solutions and Tariff Solutions based on the Oxera Report. It recommends that:

"[United Utilities Water] *Board approves the negotiation of a bulk supply agreement between United Utilities Water and Enviro-Logic at Heronbridge to supply Shotton Paper. Enviro-Logic will lead negotiations on a 'use of systems' charge with Dŵr Cymru. United*

Utilities Water will play a passive role opposite Dŵr Cymru and will simply respond to Enviro-Logic"

147. The Boulton Report explains that this approach has the following advantages*:*

> *"* [United Utilities Water's] *stance on the proposed tariff options likely to be viewed favourably by Ofwat (opportunity to open debate and force issues of "use of systems charge" and "common carriage") whilst not been* [sic] *seen as the aggressor.*
>
> - *Relatively straightforward and lowest risk solution. At as much risk if we do not proceed.*
> - [Enviro-Logic] *received a favourable response from Ofwat on discussions over a use of system charging model.*
> - [United Utilities Water] *will gain at least* £[*] *additional sales margin by selling the Heronbridge volume to Shotton on a commercial basis.*
> - *Potentially there are other Dyr* [sic] *Cymru customers that could be supplied by* [Enviro-Logic] *and/or* [United Utilities Water]*."*

148. The Boulton Report indicated that the reasons for United Utilities Water not pursuing the Engineering Options were:

> *"(i) It would be extremely costly to construct a pipeline and Shotton are not willing to contribute any funding; (ii) the* [Director] *would view as* [sic] *economically inefficient; (iii) it is unlikely that the regulator would approve of any move that would leave the first new entrant in the water industry without a customer; and (iv) constructing a pipeline would require longer timescales than a tariff options* [sic]*."*

149. It is clear from documentation provided by United Utilities Water that it had approached Shotton prior to Albion Water's Inset Appointment. In its Section 26 Notice dated 20 March 2003, we specifically asked United Utilities Water why it had ceased its attempts to supply Shotton. United Utilities Water responded that:

> *"United Utilities Water would require a long term contract in order to make any engineering based solution viable. In a meeting in 1998 (date not recorded) between K McKenzie of* [United Utilities Water] *and Shotton Paper, it was made clear that Shotton Paper did not wish to enter into a long term agreement and would require a short notice of termination clause to be included in any contract. In such circumstances no option would be viable and discussions were concluded. K McKenzie left* [United Utilities Water] *some years ago and a copy of any minutes of the meeting was either not produced or has not been retained."*

150. Tariff Options were clearly perceived as more commercially attractive (they were seen as the *"relatively straightforward and lowest risk solution"*). But the only concern that might have made Engineering Solutions economically unviable appears to have been a perceived reluctance on the part of Shotton at the time to enter into a long-term agreement, which was seen as necessary to secure the relevant investment.

151. However, we received copies of e-mail correspondence between Albion Water and United Utilities Water which refer to the possibility of constructing duplicate infrastructure to supply Shotton. Copies of this e-mail correspondence were provided by United Utilities Water in response to a Section 26 Notice dated 16 August 2002[58].

152. In an e-mail from Albion Water to United Utilities Water dated 6 December 2001, Albion Water stated:

> *"We […] need to explore an alternative approach to supplies at Shotton to increase the pressure for a favourable decision, or as a last resort, to deliver our own alternative. Jerry* [Bryan][59] *has asked me to explore costs for an alternative supply to Shotton/*[**]. *I write to see of* [sic] *you can help to quantify the cost of doing so, and to see in principle whether* [United Utilities Water] *would wish to undertake the work."*

153. The e-mail refers to two possible alternatives, namely the duplication of the Ashgrove Pipe and the construction of a pipe from the Milwr Tunnel to Shotton. The e-mail continues:

> *"At this stage the initiative needs to be absolutely confidential, and exploratory. … in the short term I have to be careful not to undermine our position that the* [Dŵr Cymru] *main is an essential facility. If we end up going for a new main to serve the site* [Enviro-Logic] *would have the support of the customer as long as we had exhausted other options first, but the financing options remain to be explored."*

154. United Utilities Water responded in an e-mail from John Lees dated 19 December 2001. It stated that:

> *"We would want to be involved in this. A fast and dirty look at the options shows them to be potentially viable to supply a competitively priced water at* [sic] *the volumes you have indicated. I would stress that it was not a detailed study, but the signs are good that it would be viable to provide a "concrete and steel" option to the existing asset usage option."*

155. This e-mail appears to imply that, on the basis of United Utilities Water's initial estimate, and subject to a more in-depth study being carried out, it appeared economic and feasible to install a duplicate pipeline running from the Heronbridge Abstraction Point to Shotton.

Importantly, the e-mail dated 6 December 2001 also appears to show that Shotton would be prepared to provide the necessary support, presumably in the form of a long-term contract. (This would be consistent with the Shotton Supply Agreement which is a 10 year agreement.)

156. We requested further details from United Utilities Water about the basis of the assessment referred to in the above e-mail. In an e-mail dated 13 November 2003 to Beryl Brown, Head of Competition Policy at Ofwat, United Utilities Water indicated that the document on which the review was based was the memo from Ken Hickman to K McKenzie dated 10 October 1997 entitled "Enviro-Logic Water Supply to Shotton".

157. United Utilities Water stated that this was a *"simplistic look at potential costs"* which it stated was demonstrated by the variations in the capital and operating costs. United Utilities Water added that this review by Ken Hickman pre-dated the Bechtel Report which provided broadly similar capital expenditure ("Capex") costs[60]. The Bechtel Report estimated the costs of constructing a 17.5 kilometre pipe between the Heronbridge Abstraction Point and Shotton to be approximately £6.5 million. It is not clear from the Bechtel Report why United Utilities Water based its assessment on a 17.5 kilometre pipe as other evidence points towards the Ashgrove Pipe being no more than 15 kilometres in length.

158. In a subsequent internal e-mail dated 20 December 2001, John Lees of United Utilities Water estimated the costs of a duplicate pipe to be circa £6 million in Capex and £350,000 in operating expenditure ("Opex").

159. When asked to clarify the basis of these figures, United Utilities Water indicated that the figures in this e-mail were also based on the review detailed in the memo from Ken Hickman dated 10 October 1997. United Utilities Water explained that the figures had been roughly adjusted to broadly take account of inflation and movements in costs since the review was carried out in 1997.

160. These figures are broadly in line with the estimates of the costs of building, and operating, a new treatment works and pipe, which we used when assessing the economic viability of duplicating the Ashgrove System. We estimated the capital cost of building a suitable treatment works on site at Shotton to treat the raw water to the standard currently carried out by the Ashgrove Treatment Works to be approximately £1.9 million. We estimated that the capital cost of building a new main (which would duplicate the Ashgrove Pipe) to be approximately £4.5 million. This produced an estimated capital cost of approximately £6.3 million. We also assumed that the operating cost of treating the water would be 2p/m^3, and the operating cost of distribution would be 1p/m^3. This produced an annual Opex of approximately £200,000 per year. These estimates were based on regulatory data

and principles (for example, our estimates of the capital costs of laying a new pipeline and treating the water were based on our current capital works cost base which consists of standardised unit costs submitted by water and sewerage companies for the coming price review in 2004). Details of how we estimated these figures, and of the results of our assessment of whether it would be economically viable to duplicate the Ashgrove System are set out in Annex 1.

161. To assess the economic viability of duplicating the Ashgrove System, we used the above costs to calculate the Net Present Value ("NPV") of such duplication. The NPV is the value today of all cash inflows netted against all cash outflows of a project lasting a number of years, based on an assumed rate of return. The rate of return is the annual income and capital growth from an investment, expressed as a percentage of the original investment. A positive NPV means that the 'present value' of all cash inflows and residual asset values are greater than the 'present value' of cash outflows taking into account an appropriate rate of return.

162. We looked at four scenarios in the NPV calculations, which differed depending on the type of new entrant, the length of asset life, and the rate of return. We then conducted a sensitivity analysis by allowing for variations in the assumptions underlying these scenarios. These variations assessed the impact of 'worst case scenarios' where, for example, costs prove to be substantially higher than estimated, and the volume of water purchased by Shotton proved to be substantially lower than estimated. Different variations also assessed the impact of a 'best case scenario' where certain costs proved to be lower than estimated, and the volume of water sold increased (because the new entrant had gained a second customer in addition to Shotton).

163. Details of the basis and results of this assessment are set out in Annex 1. However, in summary, our NPV analysis showed that in the majority of the scenarios considered, it would be economically viable to duplicate the Ashgrove System. Only one scenario which was based on an extremely unfavourable set of assumptions not normally used in the water industry and which involved a small water only undertaker ("WoC") produced a negative NPV. In all the other key scenarios that we examined the NPV was positive, demonstrating that it would be economically possible to construct duplicate infrastructure.

164. Even when we varied the assumptions underlying our analyses to look at the sensitivity of the NPV results, in two of the four key scenarios the NPV values still remain positive, even where the variations represented 'worst case scenarios'. Only in the one key scenario which involved the extremely unfavourable assumptions (and the small WoC) referred to above, did all the variations (i.e. variations representing 'best case scenarios' as well as variations representing 'worst case scenarios') continue to produce negative NPVs.

165. Overall, taking into account all the variations, we considered 32 permutations. Our analyses showed that duplication was likely to be economic, producing rates of return of 6.5% or more, in 27 of these permutations. This was despite the fact that several of our underlying assumptions were conservative.

166. In a letter dated 5 July 2001 (some 6 months before the e-mail exchange between Albion Water and United Utilities Water discussed above) Albion Water's solicitors provided what Albion Water saw as further evidence that duplication of the Ashgrove System would not be economically viable. The letter stated:

"13 […] as regards the economic viability of this option, we would draw your attention to the evidence provided to Ofwat by Dŵr Cymru in July 1996 (Bulk Supply Application by Albion Water) in which they costed a proposal to supply a major new development with an average of 18Ml/ per day untreated water, quoting a price to customer of 35p per m^3 delivered. In the same evidence they estimated that the cost of replicating the facilities to which access is sought would also lead to a unit price of 35p per m^3. These prices are far in excess of the current price to either customer on the network served by the facilities".

167. The above comments relate to correspondence provided to us by Dŵr Cymru in the context of Albion Water's Inset Application. The references to the price of 35 p/m^3 are taken from a report entitled *"Dŵr Cymru non-potable supplies – Bulk Supply Application by Albion Water Limited dated July 1996"* which was supplied to us under cover of a letter dated 5 July 1996. A subsequent letter from Dŵr Cymru to Fiona Pethick of Ofwat dated 23 July 1996 sets out the basis for the figure of 35 p/m^3.

168. Albion Water argues that this is evidence that duplication of the Ashgrove System would not be economically viable because it would result in a much higher price to the customer. However, there are significant differences between the basis on which Dŵr Cymru estimated the above costs and the basis on which it seems appropriate to assess the economic viability of duplicating the Ashgrove System in this case.

169. Dŵr Cymru's report dated July 1996 makes it clear that its calculations were based on the assumption that an additional customer with a demand of 20Ml/day moved next to Shotton. The figure of 35p/m^3 therefore refers not only to the cost of constructing an equivalent pipeline but also to the cost of increasing the resource of the River Dee. The cost of increasing the resource of the River Dee would have involved major engineering work in the form of raising the dam at Llyn Brenig and linking this reservoir with the Alwen reservoir two kilometres away. Clearly, such major work would bring with it associated costs which would need to be reflected in the price to the customer[61].

170. In contrast, in this case we have assumed that the duplication of the Ashgrove System would neither require the increasing of the resource of the River Dee nor the raising of the dam. This is because United Utilities Water has indicated that it would be able to supply Albion Water with sufficient water for Shotton's needs. As a result, we do not consider that the figure of 35 p/m^3 relied on by Albion Water represents credible evidence that it would not be economically viable to construct a duplicate pipeline and water treatment works in this case.

171. Albion Water indicated in a meeting with us on 30 July 2002 that it would be relatively easy to duplicate the Ashgrove Treatment Works. On numerous occasions, including in a letter to us dated 12 August 2003, Albion Water argued that the quality of water leaving the Ashgrove Treatment Works was not of a suitable quality for Shotton's requirements (even though there are no quality guarantees set out in the Second Bulk Supply Agreement or the Shotton Supply Agreement). Albion Water stated that, for this reason, it was proposing to install new treatment works at the Shotton site. In a letter to us dated 25 February 2003, Albion Water confirmed that it had offered to construct an on-site treatment plant with the capacity to treat 25Ml per day. Albion Water also indicated the costs to be subject to a pilot study valuation but stated that they were likely to be around £1 million. Albion Water stressed that the proposed water treatment works was not intended to replace the Ashgrove Treatment Works but to *"improve on the poor and variable quality of water produced at Ashgrove*"[62].

172. In addition, a letter from Albion Water to Dŵr Cymru of 22 March 2002 indicated that Albion Water intended to install on-site treatment facilities at Shotton. The letter explained that what Albion Water described as "*marginal treatment*" at the Ashgrove Treatment Works would:

> "*only be required until we have commissioned an advanced storage and treatment facility on the Shotton Paper site. At that time we would suggest supplying you with water treated to* [**] *specifications from the Shotton Paper site thus enabling you to decommission the* [Ashgrove Treatment Works]*."*

173. The precise nature of Albion Water's proposal to supply Dŵr Cymru is unclear. Although Albion Water indicated that this was not the case in its later letter dated 12 August 2003, the reference to constructing a water treatment works which would enable the Ashgrove Treatment Works to be "decommissioned" in the 22 March 2002 letter appears to imply that Albion Water's intention (at least at the time) was that the new treatment works would effectively duplicate the Ashgrove Treatment Works.

174. If the proposed treatment works were intended to duplicate the Ashgrove Treatment Works, then this could indicate that Albion Water considered it would be economically possible to duplicate the Ashgrove Treatment Works. At the very least, the fact that Albion Water

proposed constructing a storage and treatment works on site at Shotton gives a good indication that there are no physical and geographical constraints on building such works.

175. Moreover, in August 2002 Albion Water supplied us with details of the services it provided, or planned to provide, to Shotton[63]. Amongst the services Albion Water planned to provide to Shotton were a variety of projects involving capital expenditure. These included replacing and upgrading the pumps at the Heronbridge Abstraction Point, reinforcing the pipeline from the Heronbridge Abstraction Point to the Sealand Treatment Works and installing partial filtration for specific areas. It is quite likely that, if implemented, any such capital projects would be funded, at least in part, by Shotton. Albion Water's apparent willingness to undertake such projects again throws doubt on its assertion that the Ashgrove Pipe and Ashgrove Treatment Works cannot be duplicated for physical and economic reasons.

Conclusion on the costs of duplication

176. In summary, in light of the above, we consider that the cost of constructing new infrastructure to serve Shotton would not be sufficient to constitute a barrier to entry.

177. Our own desk-top assessment indicates that duplication would be economically viable in the vast majority of scenarios and permutations we examined. External and internal reports and e-mail correspondence demonstrate that Albion Water and United Utilities Water both considered the possibility of constructing new infrastructure. Although the Boulton Report recommends Tariff rather than Engineering Solutions, the former is seen as the lowest risk solution, rather than the only solution available. By December 2001, Albion Water thought Shotton would support the construction of new infrastructure (a perceived unwillingness to do so had previously been seen as a problem by United Utilities Water), and United Utilities Water's initial view was that duplication would be economically viable.

Time for duplication

178. The OFT Guideline, "Assessment of Market Power" (OFT 415, September 1999) explains the importance of assessing the time that it might take a new entrant to successfully enter a market when considering entry barriers. It states:

> *"5.17 […] Even when entry is not fully deterred, entrants may take time in acquiring the relevant information, raising capital and building the necessary plant and machinery. Thus, the incumbent may attract entry but retain market power for a substantial amount of time […]"*

179. Paragraph 5.27 states:

> *"It is important, if not necessarily straightforward, to assess the time that may elapse before successful (that is, profitable) entry will occur. Some producers, most likely those in neighbouring markets, may be able to enter speedily by switching the use of existing facilities. […] New entry from scratch tends to be slower than entry from a neighbouring market, for a variety of reasons – obtaining planning permission, recruiting and training staff, ordering equipment, appointing distributors and so on."*

180. In carrying out our assessment of dominance, we considered how long it might take a water and sewerage undertaker ("WaSC") or a WoC to construct a duplicate pipeline and water treatment works.

181. Albion Water has provided no indication of the time it considered it might take to construct a pipeline and water treatment works, although it did indicate that it might face delays in obtaining the necessary permission to lay pipes in private land. In a letter dated 5 July 2001[64], Albion Water argued that *"the use of pipelaying and compulsory purchase powers in order to effect delivery of the pipeline is likely to be subject to challenge by landowners and other third parties, who would object to what they would see as unnecessary disruption"*.

182. As discussed above, both Albion Water and United Utilities Water would have the necessary powers to lay relevant pipes under sections 158 and 159 WIA91, subject to the giving of reasonable notice (which is deemed to be three months) to the owner and occupier of affected land (other than in the case of pipes laid in a street where no such notice is required).

183. Including this notice period mentioned above, we estimate that the procurement of a successful design for the pipeline, and necessary easement documents, would take approximately nine months.

184. Albion Water has indicated its intention to construct a water treatment works on site at Shotton. Given that Shotton owns the land on which Albion Water proposes to construct the treatment works, it is reasonable to assume that Albion Water could commence the construction of the treatment works with minimum delay.

185. We estimate that it would then take between 12 and 18 months to actually lay the pipe in the ground and build the water treatment works. This would give an overall implementation time of between 21 and 27 months.

186. The water industry is a long-term industry. It is not unusual for large industrial customers to enter into long term supply agreements, on the basis of which undertakers recoup the costs of building new capital infrastructure used to supply the customer's premises. Inset Appointments were introduced (in the Competition and Service (Utilities) Act 1992) to constrain the market power enjoyed by

incumbent undertakers, and it can take several years from an application being submitted for an Inset Appointment to be granted. However, once an Inset Appointment has been granted, the new entrant's Licence is not time limited (even though Albion Water's Licence can be terminated following one year's notice, the Licence will continue unless and until the National Assembly for Wales serves the notice). In short, an incumbent undertaker knows that once it loses a customer, it will almost certainly have lost that customer for the duration of a long term contract (typically a ten to twenty five year contract) or permanently.

187. There is evidence of instances where new entrants have constructed pipelines to serve customers outside their areas, in particular where an Inset Appointee has constructed a new pipeline to serve a new customer.

188. For example, Anglian Water Services Limited ("Anglian") was granted an Inset Appointment to supply Buxted Chicken Limited ("Buxted"), a chicken processing factory formerly in Essex & Suffolk Water's Water Supply Area. Anglian laid 3.5 kilometres of dedicated pipeline to supply Buxted directly from one of its own water treatment works.

189. Consequently, we consider that the length of time it would take for a WaSC or a WoC new entrant to construct the necessary infrastructure to supply Shotton would not amount to an insurmountable barrier to entry, and would not prevent a WaSC or a WoC constraining an incumbent undertaker's market power through constructing, or threatening to construct, such infrastructure.

190. The WaSC or relevant WoC would only start to receive revenues from its customer following completion of the construction. It would therefore incur investment costs before it began to receive revenues from the project. Although there may be cases where a lack of revenues during the implementation of a project could be problematic, in practice the WaSC or relevant WoC would incur little expenditure during the nine-month period for the service of legal notices and the procurement process. After this point it would incur investment costs gradually over the remaining 12 to 18 months of the project. To allow for this delay in receiving revenues and to simplify the NPV calculations we considered in Annex 1, we assumed that all the investment costs are paid in year zero of the project and that no revenues are earned until year one.

191. We do not consider that the fact that a WaSC or a WoC would receive no revenue during the construction process would itself represent an insurmountable barrier to entry. In the examples of new entrants constructing new pipes discussed above, the cost of the new pipeline (including financing costs) was recouped through water charges paid by new customers connected to the water main. The construction of

the new pipelines in these cases was therefore expected to be profitable.

Exclusionary behaviour

192. The third type of barrier to entry cited in the OFT Guideline, "Assessment of Market Power" is created by exclusionary behaviour by the incumbent. An example of such exclusionary behaviour would be where a company deliberately charges below the cost of a product or service with the intention of driving a competitor from the market, so as to be able to charge excessive prices in the future (i.e. "predatory pricing").

193. In its letter of 12 August 2003, Albion Water argued that the risk of Dŵr Cymru offering a water supply to Shotton at a lower price than Albion Water's price "*would render impossible the raising of finance for the duplication of existing assets*". The paragraphs below therefore consider to what extent Dŵr Cymru would be able to offer a lower retail price to Shotton in response to competition from other parties.

194. The Water Industry Act 1999 (WIA99) amended WIA91 to require all companies to have a charges scheme approved by the Director. Companies are responsible for deciding individual charges. In approving charges schemes we need to ensure that they are consistent with:

(a) Licence Condition B which requires charges to comply with price limits;

(b) Licence Condition E which requires that tariffs should not be unduly preferential or unduly discriminatory against any class of customers or potential customers;

(c) guidance on charging matters from the Secretary of State[65] and the Welsh Assembly Government[66]; and

(d) our duty to protect customers[67].

195. Many undertakers have arrangements with particular customers where the customer pays a non-standard charge to reflect their individual circumstances. For example, the customer might have made an initial capital contribution to the undertaker in return for which the customer pays a lower price over time.

196. These non-standard charges are commonly known as "special agreements" and those agreed or renewed since 1989 are subject to Licence Condition E. We consider that a special agreement satisfies Licence Condition E if the difference between the charges contained within it and those in other tariffs reflects the difference in service received, making adjustments for any contributions the customer may

have made in the past. CA98 applies to all special agreements regardless of when they were agreed. Historically, Shotton has been charged by reference to an individual special agreement, rather than on a standard tariff.

197. We carry out an annual review and approval process for standard water and sewerage tariffs for England and Wales in order to fulfil the requirements of WIA91 (as amended by WIA99). This process has been applied to Dŵr Cymru's standard charges since 1999.

198. Dŵr Cymru proposed a new tariff for 2003/2004 including volumetric charges for raw water and partially treated water[68]. The charges introduced under this tariff have subsequently been revised for 2004/2005. (Elsewhere in this decision, that tariff, as it would apply to Shotton were Dŵr Cymru ever to supply Shotton directly again, is referred to as the "New Tariff". Taking account of the fixed charge in the New Tariff and assuming current volumes of water supplied to Shotton remain unchanged, it would equate to 26.6 p/m^3 for Shotton in 2004/2005, slightly above the price in the Second Bulk Supply Agreement.) We examined and approved these tariffs as part of the annual tariff review and approval process.

199. If Dŵr Cymru were to seek to regain Shotton as a customer, and it wanted to offer to supply Shotton at a lower tariff than the New Tariff, it would have to obtain approval from us as part of this established annual tariff approval process. This lower tariff would then be available to any of Dŵr Cymru's customers with similar volume and quality requirements.

200. Similarly, if Dŵr Cymru were to seek to regain Shotton as its customer, and it wished to offer a new special agreement to Shotton, this would have to be linked to particular circumstances which related to the costs of supplying any customer requiring similar volumes and quality of water services. We advise water companies that details of any new special agreements should be made available to us for scrutiny ahead of implementation (although we do not formally approve them under WIA91).

201. The approval of Dŵr Cymru's standard non-potable tariffs for 2003/2004 largely identified the cost elements which would underpin the terms associated with any new special agreement. Consequently, following the introduction of the new standard non-potable tariffs, the scope for Dŵr Cymru to offer a reduced price for water services to Shotton via a new special agreement would appear to be limited.

202. It is therefore unlikely that Dŵr Cymru could offer a retail price to Shotton (whether via an approved tariff or a special agreement) which was to any appreciable extent lower than the New Tariff, without some fundamental change in the existing circumstances of the supply required by Shotton, such as a change in the quality of water required.

203. Consequently, we have concluded that, due to the nature of the regulatory regime and particularly our role in approving standard non-potable (as well as potable) tariffs, even if Dŵr Cymru wished to react to plans to build new infrastructure (by, for example, Albion Water or United Utilities Water) by lowering the prices available to Shotton, it would be unlikely that it could offer a retail price to Shotton significantly below the New Tariff. Indeed, the fact that our standard tariff approval process takes place annually and takes into consideration cost elements means that it would be extremely difficult for a company such as Dŵr Cymru to reduce a tariff without appropriate justification.

Other factors relevant to the assessment of dominance/market power

Buyer Power

204. Paragraph 6.1 of the OFT Guideline, "Assessment of Market Power" states that, *"The main potential constraint on market power of a seller is the strength of buyers and the structure of the buyers' side of the market. The potential market power of a seller is offset by the buying power of a buyer if, in the absence of that buyer, prices would have been higher. Buyer power allows an undertaking (or a group of undertakings acting together) to exert a substantial influence on the price, quality or the terms of supply of a good purchased. It requires that a buyer should be large, in relation to the relevant market, well informed about alternative sources of supply and that the buyer could readily, and at little cost to itself, switch from one supplier to another, or even commence production of the item himself".*

205. It is sometimes possible for customers to access their own water source (through, for example, a borehole on land owned by the customer), and to construct a pipe to link that water source to its premises. Although [**] has access to boreholes it owns, we have not seen any evidence that the same is true of Shotton, nor have we investigated whether or not this is the case.

206. In the absence of an alternative water source of this type, it appears that customers' buyer power in this case may depend on the possibility of changing the customers' water supplier from the incumbent undertaker to a third party, either an unregulated supplier (providing a so-called "private supply"[69]) or new entrant who has obtained an Inset Appointment. However, if buyer power is assessed in relation to a market for the treatment and distribution of water, it is likely that the private supply or Inset Appointment would have to involve the private supplier or the Inset Appointee constructing new pipes, usually to a new water source. If the private supplier or the Inset Appointee were simply using the incumbent undertaker's treatment works and pipes (as Albion Water is now), the incumbent undertaker might simply seek to recover from the private supplier or Inset Appointee the same charge

for treatment and distribution which it previously recovered from the end customer.

207. In practice, this may mean that customers only have any meaningful buying power in certain narrowly defined circumstances. First, they would need to be either "large users", or own "green-field" sites to be able to attract Inset Appointees. Second, they would need to be large in relation to the relevant market, which would mean that they would have to be purchasing a material volume of water. Third, in order to exercise any buyer power in relation to the treatment and distribution of water (assuming that the customer had no water sources on site), it would have to be economically viable for the private supplier or the Inset Appointee to build the necessary treatment works and infrastructure to link the relevant water source to the customer's premises.

208. For these reasons, again assuming that the customer does not have its own water source, a customer's buyer power is linked to the availability of potential competitors to the incumbent undertaker. If there are no potential competitors available, and the customer has no water of its own, it has nowhere to go but to the incumbent undertaker for treatment and distribution of its water. The incumbent undertaker's charges for the whole supply (including the cost of water resources) may be constrained by regulation, but not by buyer power.

209. Unusually however, it appears that Shotton may meet the above criteria. We are not aware of any potential private suppliers, but Shotton has been able to attract an Inset Appointee (Albion Water). It does purchase a material volume of water. And, on the basis of our conclusions above, it does appear that there are potential competitors who could compete with Dŵr Cymru in the relevant market (indeed Albion Water was granted its Inset Appointment in the expectation that it would develop a new water source which would involve constructing new infrastructure).

Conduct

210. Paragraph 6.3 of the OFT Guideline, "Assessment of Market Power" states that an undertaking's conduct in a market may, in itself, provide evidence that it possesses market power. It indicates that it might, for example, be reasonable to infer that an undertaking possesses market power from evidence that it has consistently raised prices in excess of costs. Please see paragraphs 250 to 371 below which set out our views on the access price offered by Dŵr Cymru.

211. Paragraph 6.6 of the same OFT Guideline notes that an undertaking might face constraints in the form of regulation. The setting of access prices on their own (as opposed to, for example, the distribution element of a tariff) is not currently regulated under WIA91, although it will be under WIA91 as amended by WA03 when the relevant

provisions come into force. However, it may be that an undertaker's approach to access pricing could have implications for its setting of charges which are regulated under WIA91, and vice versa. For example, please see our comments on the First Access Price, the Second Access Price and the New Tariff in the "Abuse" section of this decision below. It is not therefore impossible that there might be indirect constraints on undertakers' setting of access prices through the regulation of different, but possibly related, charges. However, in light of our conclusions below, ultimately we have not found it necessary to reach a final view on this point.

Conclusion on Dominance

212. In paragraph 4.22 of the Ofwat Guideline, we comment that, *"While the definition of an essential facility must be undertaken on a case by case basis, many of the capital assets of water and sewerage undertakers could be regarded as essential facilities"*. Although this statement relates to essential facilities, it reflects a view that, in many markets within the water and sewerage industries in England and Wales, undertakers might be in a dominant position. There are certain factors in this case which would point strongly to Dŵr Cymru being in a dominant position on the relevant market. First, albeit depending very much on the precise market definition used, Dŵr Cymru might have had a 100% market share at all material times. Second, for whatever reason, no company has yet duplicated the Ashgrove System. Third, we have not seen any evidence that Dŵr Cymru itself felt constrained by the emergence of Albion Water during the Inset Application process (or by any other competitor), although we have not expressly sought such evidence.

213. On the other hand, when assessing dominance, the particular circumstances of this case are unusual for the following reasons. First, as discussed above, the definition of the relevant market may in fact be wider than that put forward by Albion Water (and which we have used a starting point in this decision). The market definition could be widened to include the treatment and transportation of water to customers other than Shotton and [**], to include infrastructure other than the Ashgrove System (exceptionally the geographic area in which the Ashgrove System and Shotton are situated is in close proximity to the Water Supply Areas of three water undertakers in addition to Albion Water), and/or to relate to the treatment and transport of water abstracted within, for example, the relevant water resource zone, rather than a single abstraction point. A wider market definition might result in market shares being split between Dŵr Cymru, United Utilities Water, and Dee Valley. It is not insignificant that United Utilities Water had itself considered building new pipes to supply Shotton itself.

214. Second, there do appear to be potential competitors which could represent a constraint on Dŵr Cymru's ability to behave independently. In particular, we do not agree with Albion Water's arguments that Dŵr Cymru benefits from any absolute advantages (in the form of pipelaying powers or abstraction rights) which would prevent Albion Water, or United Utilities Water, from entering the market. We also do not agree with Albion Water's arguments that Dŵr Cymru has strategic advantages which would represent a barrier to entry, because it would be uneconomic to duplicate the Ashgrove System. We also believe that it would be unlikely that Dŵr Cymru could engage in exclusionary behaviour by, for example, lowering its retail price to Shotton significantly below the New Tariff which has been approved by us under WIA91.

215. In light of the above, although it may be unusual, we do have reservations about whether Dŵr Cymru could actually be said to be in a dominant position, on the basis of the evidence before us. However, in light of our conclusions in this decision, ultimately we have not found it necessary to carry out a more detailed analysis of dominance, or to reach a final view on this point. Nevertheless, and for the purpose of analysing Albion Water's allegations that Dŵr Cymru has engaged in abusive conduct, we have made the assumption that Dŵr Cymru does hold a dominant position on the relevant market.

'<u>Essential Facilities</u>'

216. In alleging that Dŵr Cymru had breached the Chapter II Prohibition, Albion Water maintained that the Ashgrove System, to which it sought access, was an 'essential facility'. The jurisprudence of the European Commission and the European Courts establishes that a company which has a dominant position in the provision of the facilities which are essential for the supply of goods or services on another market abuses its dominant position where, without objective justification, it refuses access to those facilities.

217. According to the ECJ in *Oscar Bronner v Mediaprint and Others ("Oscar Bronner")*[70] in order to establish that refusal of access to a facility or service constitutes a breach of Article 82, it is necessary to establish three requirements:

(a) that the refusal is likely to eliminate all competition in the market on the part of the person requesting the access;

(b) that such refusal is incapable of being objectively justified; and

(c) that the facility or service in itself is indispensable to carrying on that person's business, in as much as there is no actual or potential substitute in existence for that facility or service.

218. In his opinion on *Oscar Bronner,* which was endorsed by the ECJ in its judgment, Advocate General Jacobs said in relation to an obligation on a dominant undertaking to supply a product or service or to allow access to a facility:

"65. It seems to me that intervention of that kind, whether understood as an application of the essential facilities doctrine or, more traditionally, as a response to a refusal to supply goods or services, can be justified in terms of competition policy only in cases in which the dominant undertaking has a genuine stranglehold on the related market. That might be the case, for example, where duplication of the facility is impossible or extremely difficult owing to physical, geographical or legal constraints or is highly undesirable for reasons of public policy. It is not sufficient that the undertaker's control over a facility should give it a competitive advantage.

66. I do not rule out the possibility that the cost of duplicating a facility might alone constitute an insuperable barrier to entry. That might be so particularly in cases in which the creation of the facility took place under non-competitive conditions, for example, partly through public funding. However, the test in my view must be an objective one: in other words, in order for refusal of access to amount to an abuse, it must be extremely difficult not merely for the undertaking demanding access but for any other undertaking to compete. Thus, if the cost of duplicating the facility alone is the barrier to entry, it must be such as to deter any prudent undertaking from entering the market."

219. Advocate General Jacobs also said at paragraph 51 of his opinion: *"The test applied is an objective one, concerning competitors in general. Thus a particular competitor cannot plead that it is particularly vulnerable"*.

220. In *IMS Health GmbH & Co. OHG v. NDC Health GmbH & Co. KG*,[71] the ECJ considered *Bronner*, and clarified the scope of application of the essential facilities doctrine. It stated, at paragraph 49 of the judgment:

"Therefore, the refusal by an undertaking in a dominant position to allow access to a product protected by copyright, where that product is indispensable for operating on a secondary market, may be regarded as abusive only where the undertaking which requested the licence does not intend to limit itself essentially to duplicating the goods or services already offered on the secondary market by the owner of the copyright, but intends to produce new goods or services not offered by the owner of the right and for which there is a potential consumer demand." At paragraph 52, the ECJ stated*:*

"Accordingly, the answer to the first question must be that the refusal by an undertaking which holds a dominant position and is the owner of an intellectual property right over a brick structure which is indispensable for the presentation of data on regional sales of pharmaceutical products in a Member State, to grant a licence to use that structure to another undertaking which also wishes to supply such data in the same Member State, constitutes an abuse of a dominant position within the meaning of Article 82 EC where the following conditions are fulfilled:

- *the undertaking which requested the licence intends to offer, on the market for the supply of the data in question, new products or services not offered by the copyright owner and for which there is a potential consumer demand;*
- *the refusal is not justified by objective considerations;*
- *the refusal is such as to reserve to the copyright owner the market for the supply of data on sales of pharmaceutical products in the Member State concerned by eliminating all competition on that market".*

221. CA98 does not define 'essential facility.' However, under section 60 CA98 the Director must, so far as possible having regard to any relevant differences between the provisions concerned, have due regard to the treatment of questions arising under European Community law, when assessing cases in the context of the 'essential facilities' doctrine.

222. In this case, if the Ashgrove System were not indispensable, it would not constitute an 'essential facility'. During our investigation we received information about a number of potential alternative ways of supplying water to Shotton other than through the Ashgrove System (including, for example, options using other existing pipes, canals, and aqueducts not owned by Dŵr Cymru). If any one of these ways were viable and provided a real alternative to the Ashgrove System, the Ashgrove System would not represent an 'essential facility'. As part of our analysis set out in the "Dominance" section above, we concluded that the cost of constructing new infrastructure to serve Shotton would not be sufficient to constitute a barrier to entry. We are not satisfied that there are technical, legal or economic obstacles making it impossible or unreasonably difficult to construct such infrastructure.

223. In many circumstances, the construction of duplicate water supply infrastructure could be contrary to public policy. In some cases, this could create inefficiencies and could result in unnecessary capital costs which would ultimately have to be recovered from customers. However, exceptionally, in this particular case there may not be sufficient public policy reasons to render the Ashgrove System an essential facility. For example, the alleged 'essential facility' in this

case is not a large pipe network but a short pipeline of no more than 15 kilometres serving only two large industrial customers.

224. Further, at the time of Albion Water's Inset Appointment, it planned to develop an alternative source of water with which to supply Shotton, which would have required new infrastructure. The Inset Appointment was actually granted in the expectation that Albion Water would develop its own water source. Finally, new infrastructure is not necessarily inefficient, particularly if a number of customers can be linked to it, possibly freeing up capacity in existing infrastructure.

225. Although we would need to examine particularly the public policy questions in more detail, at this stage we do not believe that the Ashgrove System is an essential facility as Albion Water alleges. But in light of our conclusions in this decision set out below, we have not found it necessary to rely on this view in this case.

C. ABUSE

Price related alleged breaches of the Chapter II Prohibition

226. Albion Water alleged that Dŵr Cymru had breached the Chapter II Prohibition for a number of reasons relating to the First Access Price. In particular, Albion Water alleged that the First Access Price offered by Dŵr Cymru was excessive, amounted to "price squeezing", and was discriminatory. The following paragraphs look in detail at those aspects of the complaint and set out our conclusions.

Excessive Pricing

Legal Test

227. Section 18(2)(a) CA98 provides that conduct by a dominant undertaking may constitute an abuse, in breach of section 18(1) CA98, if it consists in:

> *"directly or indirectly imposing unfair purchase or selling prices".*

228. Article 82(2)(a) of the Treaty contains similar provisions. The ECJ has held that it is an abuse under Article 82 of the Treaty for a dominant undertaking to charge excessively high purchase or selling prices.

229. In *General Motors*[72], the ECJ stated that an undertaking in a position of legal monopoly, with the freedom of the manufacturer or sole authorised agent to fix the prices for its services, might abuse the market by fixing its price at a detrimental level:

> *"It is possible that the holder of the exclusive position referred to above may abuse the market by fixing a price – for a service*

> *which it is alone in a position to provide – which is to the detriment of any person acquiring* [that service]*"*[73].

230. The ECJ indicated that a price could be unfair and abusive if it was excessive when judged in relation to the economic value of the service provided:

> *"such an abuse might lie, inter alia, in the imposition of a price which is excessive in relation to the economic value of the service provided"*[74].

230. In *United Brands v. Commission*[75] ("*United Brands*"), the ECJ held that charging a price which is excessive because it has no "reasonable relation" to the economic value of the product supplied may be an abuse:

> *"248. The imposition by an undertaking in a dominant position directly or indirectly of unfair purchase or selling prices is an abuse to which exception can be taken under Article 82 of the Treaty.*
>
> *249. It is advisable therefore to ascertain whether the dominant undertaking has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition.*
>
> *250. In this case charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be such an abuse.*
>
> *251. This excess could, inter alia, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production, which would disclose the amount of the profit margin;[…].*
>
> *252. The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive and, if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products".*

231. In *Napp*, the Tribunal, having cited the ECJ's judgment in *United Brands,* endorsed the Director General of Fair Trading's statement that, as a matter of principle, a price is excessive for the purposes of the Chapter II Prohibition:

> *"if it is above that which would exist in a competitive market and where it is clear that high profits will not stimulate successful*

> *new entry within a reasonable period. Therefore, to show that prices are excessive, it must be demonstrated that (i) prices are higher than would be expected in a competitive market, and (ii) there is no effective competitive pressure to bring them down to competitive levels, nor is there likely to be"*[76].

232. In paragraphs 4.7 to 4.10 of the OFT Guideline, "The Chapter II Prohibition" (OFT 402, March 1999), the OFT gives the following guidance on excessively high prices as a form of abuse:

> *"The essential issue is when a price becomes* ***excessively high****: in general to be excessively high the price must be higher than it would normally be in a competitive market. Clearly all companies must earn some level of profits in order to finance investments. The profits of a dominant undertaking in the relevant market consistently exceeding its relevant cost of capital (the return which could be earned from investing elsewhere having regard to the risks incurred by investing in the particular company) might, however, indicate that its prices were excessive.*
>
> *There may, however, be many justifications for prices which are apparently "excessively high". First, in competitive markets, prices and costs vary over time and there are likely to be periods when high profits can be earned. This is an important part of the competitive process since it can encourage increased output or entry to a market. Secondly, undertakings in competitive markets may be able to sustain high profits for a period of time if they are more efficient than their competitors. This might occur if an undertaking has developed lower-cost techniques of production, supplies higher quality products or is more effective at identifying market opportunities. (Exclusive access to low-cost inputs, such as exclusive rights to certain raw materials, is not, however, the same thing as superior efficiency.) To be an abuse, prices would have to be persistently excessive without stimulating new entry or innovation.*
>
> *Given the uncertainties in estimating what an undertaking's cost of capital should be, prices would have to allow profits which significantly and persistently exceeded its cost of capital before an abuse could be established".*

233. Assessing whether or not access prices are excessive in the water industry is particularly difficult, as it can be for other network industries such as the telecommunications industry. However, the European Commission's "Notice on the application of the competition rules to access agreements in the telecommunications sector"[77] ("Telecommunications Notice") provides some guidance, which can be applied by analogy to the water industry. The Telecommunications Notice represents a relevant statement of the European Commission to

which we must have regard under section 60(3) CA98. The Telecommunications Notice states:

> *"104 In determining whether there is a pricing problem under the competition rules, it will be necessary to demonstrate that costs and revenues are allocated in an appropriate way. Improper allocation of costs and interference with transfer pricing could be used as mechanisms for disguising excessive pricing, predatory pricing or a price squeeze.*
>
> *Excessive pricing*

[…]

> *106 An excessive price has been defined by the Court of Justice as being 'excessive in relation to the economic value of the service provided'. In addition the Court has made it clear that one of the ways this could be calculated is as follows: 'This excess could, inter alia, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its cost of production'*
>
> *107 It is necessary for the Commission to determine what the direct costs for the relevant product are. Appropriate cost allocation is therefore fundamental to determining whether a price is excessive. For example, where a company is engaged in a number of activities, it will be necessary to allocate relevant costs to the various activities, together with an appropriate contribution towards common costs. It may also be appropriate for the Commission to determine the proper cost allocation methodology where this is a subject of dispute.*
>
> *108 The Court has also indicated that in determining what constitutes an excessive price, account may be taken of Community legislation setting out pricing principles for the particular sector.*
>
> *109 Further, comparison with other geographic areas can also be used as an indicator of an excessive price: the Court has held that if possible a comparison could be made between the prices charged by a dominant company, and those charged on markets which are open to competition. Such a comparison could provide a basis for assessing whether or not the prices charged by the dominant company were fair. In certain circumstances, where comparative data are not available, regulatory authorities have sought to determine what would have been the competitive price were a competitive market to exist. In an appropriate case, such an analysis may be taken into*

account by the Commission in its determination of an excessive price".

234. As stated in paragraph 107 of the Telecommunications Notice "*Appropriate cost allocation is [….] fundamental to determining whether a price is excessive*". In light of this and the case-law referred to above, we have considered the following three questions when assessing whether or not the First Access Price is excessive:

(a) Did Dŵr Cymru misallocate any costs when calculating the First Access Price?

(b) Does the First Access Price bear no reasonable relation to the economic value of the service provided, when judged by reference to the difference between the costs actually incurred by Dŵr Cymru and the price charged?

(c) if the answer to (b) is in the affirmative, was the First Access Price unfair either in itself or when compared to competing services?

Albion Water's arguments

235. In relation to the first question, namely whether there was any misallocation of costs by Dŵr Cymru, Albion Water challenged in detail the way in which Dŵr Cymru had calculated the First Access Price. As discussed in paragraphs 403 and 404 below, Albion Water also alleged that Dŵr Cymru had *"knowingly and willingly"* misallocated costs. Albion Water's criticisms of Dŵr Cymru's calculation of the First Access Price, and our views are discussed in paragraphs 250 to 306 below.

236. Albion Water also argued that the First Access Price was unreasonable and/or excessive because of the extent to which it exceeded Albion Water's estimate of the direct costs of the supply, based on Albion Water's belief at the time that the relevant class of customer should comprise only Shotton and [**]. For example, in Albion Water's letter dated 25 January 2001 it set out what it thought was an appropriate approach to assessing an access price, stating, *"a test of 'reasonableness' could also be applied to the outcome of this exercise as a check of its robustness.* [Albion Water's] *offer of an access price of 7 p/m^3 was based on current replacement costs of the existing system [...] plus an appropriate apportionment of the costs. Dŵr Cymru's request for 20 p/m^3 [78] is far removed from this figure because it appears to be based on the apportionment of costs that are clearly not appropriate to this class of customer"*.

237. On the basis of its views on Dŵr Cymru's allocation of costs in the First Access Price, Albion Water argued that the First Access Price was excessive and that Dŵr Cymru was making supra-normal profits. Albion Water referred expressly to section 18(2)(a) CA98, for example,

in its letter of 11 December 2000, and to "unreasonable" pricing by Dŵr Cymru, for example in its solicitors' letter of 5 July 2001. Albion Water argued in its letter dated 21 December 2001that it had *"provided ample evidence to demonstrate that Dŵr Cymru is making supra-normal profits in the relevant market [...]"*.

238. Albion Water also argued that the First Access Price was inconsistent with our Regulatory Accounting Guidelines ("RAGs") and these arguments are considered in paragraphs 308 to 316 below.

239. In addition to looking at Dŵr Cymru's methodology and calculation of the First Access Price, we also considered the First Access Price under the Efficient Component Pricing Rule ("ECPR") and under the Costs Principle set out in WA03. (See paragraph 244 below for an explanation of the Costs Principle.)

Access pricing in the Water Industry

240. At the time of Albion Water's complaint, there was no specific statutory framework for common carriage or any particularly favoured method within the water industry for calculating access prices. We had sent a public letter to Managing Directors of water undertakers in June 2001 ("MD 163") about "Pricing Issues for Common Carriage". This letter set out the main possible approaches to access pricing.

241. In MD 163, we said:

"*There are many different ways of calculating access prices, but the list of alternatives can be grouped into three main approaches. Specifically, access prices can be based on:*

1. *Accounting costs (i.e. the book value of the assets to which access is sought).*
2. *The long-run marginal cost (LRMC)[79] of that part of the incumbent's system to which access is sought.*
3. *The Efficient Component Pricing Rule (ECPR).*

Most companies have indicated that they intend to charge for use of their systems principally on the basis of the book value of their assets. Some companies have indicated that entrants will, where appropriate, be charged for any incremental costs associated with access (e.g. including the cost of new investment), although none has suggested that it would charge purely on the basis of LRMC.

Two companies have indicated that they may use ECPR. This approach can be summarised by a simple equation in which the access price is given by the incumbent's final product price less the costs it would avoid by providing access. For example, a new entrant wishing to access an incumbent's arterial and local distribution network would be charged the difference between the incumbent's final product price

and the avoidable costs of resources, treatment and customer service."[80]

242. We produced draft guidance on "Access Codes for Common Carriage" in September 2001, which was finalised in March 2002. In that guidance, we noted:

"In principle, none of the three main approaches to calculating access prices is unreasonable under CA98. Ofwat does not, therefore, have the power under current legislation to require companies to adopt a single method."

243. When companies produced their public access codes, a number had based their access price calculations on ECPR. Most had used Average Accounting Costs ("AAC"). Although one company did refer generally to the principles of LRMC, none had explicitly used LRMC (and we have not therefore considered an LRMC approach further).

244. WA03, when implemented, will change this position significantly, by introducing specific duties on water undertakers to allow common carriage and by stipulating in section 66E WIA91 the type of costs that undertakers are allowed to recover ("the Costs Principle") in doing so. The Costs Principle provides for a "retail-minus" approach to access pricing. This is explained in more detail in paragraphs 317 to 331 below on ECPR (as ECPR is a type of "retail-minus"[81] approach).

<u>The Average Accounting Costs Method used by Dŵr Cymru</u>

245. Dŵr Cymru offered Albion Water the First Access Price of 23.2 p/m^3 in February 2001. Dŵr Cymru based the First Access Price on an AAC method, or as Dŵr Cymru called it, on a "whole company average basis".

246. Dŵr Cymru set out the method it had used for calculating the First Access Price in a letter to Ofwat on 20 February 2001. It provided further detail in its 10 August 2001 letter in response to the Section 26 Notice sent to it on 29 June 2001, and in a supplement to its response sent on 5 September 2001. We met representatives of Dŵr Cymru at Dŵr Cymru's premises on 17 October 2002 to discuss Dŵr Cymru's access price methodology.

247. At the time Dŵr Cymru offered the First Access Price, it did not have a general tariff for non-potable water upon which it might have based the First Access Price. However, subsequently Dŵr Cymru proposed new large user tariffs for 2003/04 which included volumetric charges for both raw water and partially treated water. We examined and then approved these under the established annual tariff review and approval process under WIA91. The new tariff ("New Tariff") which would apply to Shotton, in 2004/2005, if Dŵr Cymru were to supply Shotton directly,

would equate to a unit price of 26.6 p/m^3 (this single figure takes account of the annual fixed charge which would be imposed, assuming current volumes of water supplied do not change).

248. Dŵr Cymru's approach to the First Access Price and its approach to the New Tariff are similar. Dŵr Cymru based the New Tariff on a similar seven stage approach to that it had used when calculating the First Access Price. We have therefore examined the First Access Price in light of the assumptions which underpin the New Tariff. We have not considered whether the New Tariff itself could amount to the abuse of a dominant position by Dŵr Cymru (generally we would address tariff related issues under the WIA91 annual approval process).

249. Following the approval of the New Tariff under WIA91, we asked Dŵr Cymru how the New Tariff would affect the access price it would offer Albion Water in this case. In a letter dated 16 January 2004, Dŵr Cymru confirmed that, in light of the New Tariff, the indicative 2003/04 access price for the treatment and transport of non-potable water could be 17.74 p/m^3, which would be a starting point for any new application but which did not include "any other administrative and associated costs" (the "Second Access Price"). Dŵr Cymru also indicated in its letter of 13 May 2004 that the New Tariff included certain "business activities" (such as customer service, scientific services and debt/rates related costs), at least a portion of which Dŵr Cymru might have sought to include in the final access price, depending on the exact nature of the access service sought and provided. There are similarities between the way Dŵr Cymru calculated the New Tariff and the way it calculated the Second Access Price, and these are referred to below. We have not considered whether the Second Access Price itself would amount to the abuse of a dominant position by Dŵr Cymru.

The First Access Price

250. The First Access Price offered by Dŵr Cymru was 23.2 p/m^3. Dŵr Cymru's approach to calculating the First Access Price involved seven stages, which are described in detail below, together with comments from Albion Water and our comments. A table summarising this seven stage process is provided in paragraph 304 below.

251. The treatment and distribution elements of the First Access Price were calculated separately. In calculating both these elements, Dŵr Cymru began with its revenues from both potable and non-potable supplies as a proxy for average costs, and then made adjustments, if appropriate, to reflect the fact that this case involved the treatment and distribution of non-potable water only. In its letter of 8 March 2001, Albion Water criticised Dŵr Cymru for basing the First Access Price on prices to consumers, not on the allocation of costs. In that letter, it stated, *"Failure to comply with MD 163 which clearly states that access charges should allow incumbents to recover network costs and that*

companies should charge entrants as it would charge itself [sic]*. To base charges on income is clearly inconsistent with these guidelines. In the short run it is unreasonable to assume that current income is entirely representative of current network costs."* With regard to the distribution element of the First Access Price calculation, Albion Water also criticised Dŵr Cymru's process of deduction in its solicitors' letter of 5 July 2001. It said, *"If these inaccuracies and inconsistencies were corrected the effect on Dŵr Cymru's calculations would still lead to an unreasonable result, as it would increase the Water Bulk Distribution figure* […] *by the whole amount of any difference, as this value is arrived at not by assessment of cost, but by deduction (the Tariff, minus the proportion attributed to treatment, equals the distribution value). Again, these figures should be cost reflective."*

252. Initially, Albion Water argued that the First Access Price should be based on the direct costs of supplying Shotton, or the costs of supplying Shotton and [**]. However, Albion Water has since accepted that access prices can be based on average regional costs, rather than such direct costs[82]. We continually encourage undertakers to refine and enhance their tariffs for different classes of customers to ensure each tariff reflects the cost of supplying that class as far as possible. Historically charges for water and waste water services have been set without any specific reference to where each individual customer is located, or the specific costs of supplying each customer. There is no specific "distance related"[83] charging, and there are many common costs in the industry (which are not straightforward to allocate to particular activities). Undertakers recover the total amount of revenue they are entitled to recover under price determinations through charges which are based on the average costs of supplying all customers in each undertaker's Water Supply Area ("regional average charging").

253. Historically undertakers have not needed to collect for regulatory purposes individual costs data such as, for example, the direct costs of treating and distributing water through the Ashgrove System to Shotton. In principle, it would be possible to estimate the direct costs of supplying Shotton. However, for the purposes of both case-specific common carriage access prices and case-specific retail prices, undertakers would still need to allocate an appropriate share of common costs. Determining an appropriate share of common costs would not be straightforward as there are a number of justifiable allocation approaches which would be likely to result in significantly different cost figures. If the access price were calculated in this way in a particular case, undertakers would immediately come under pressure to move away from regional average retail prices generally towards more case-specific retail pricing (in a type of process sometimes referred to as "de-averaging") from those customers who would benefit from such de-averaging. This de-averaging would raise serious difficulties under WIA91. For example, de-averaging would be likely to result in considerable price rises for some customers which might be inconsistent with the Director's Section 2 WIA91 Duties and guidance

from the Secretary of State under the Water Industry Act 1999 on price stability, predictability, fairness and affordability. Given this, regulated charges for water and waste water services continue to be based on regional average costs.

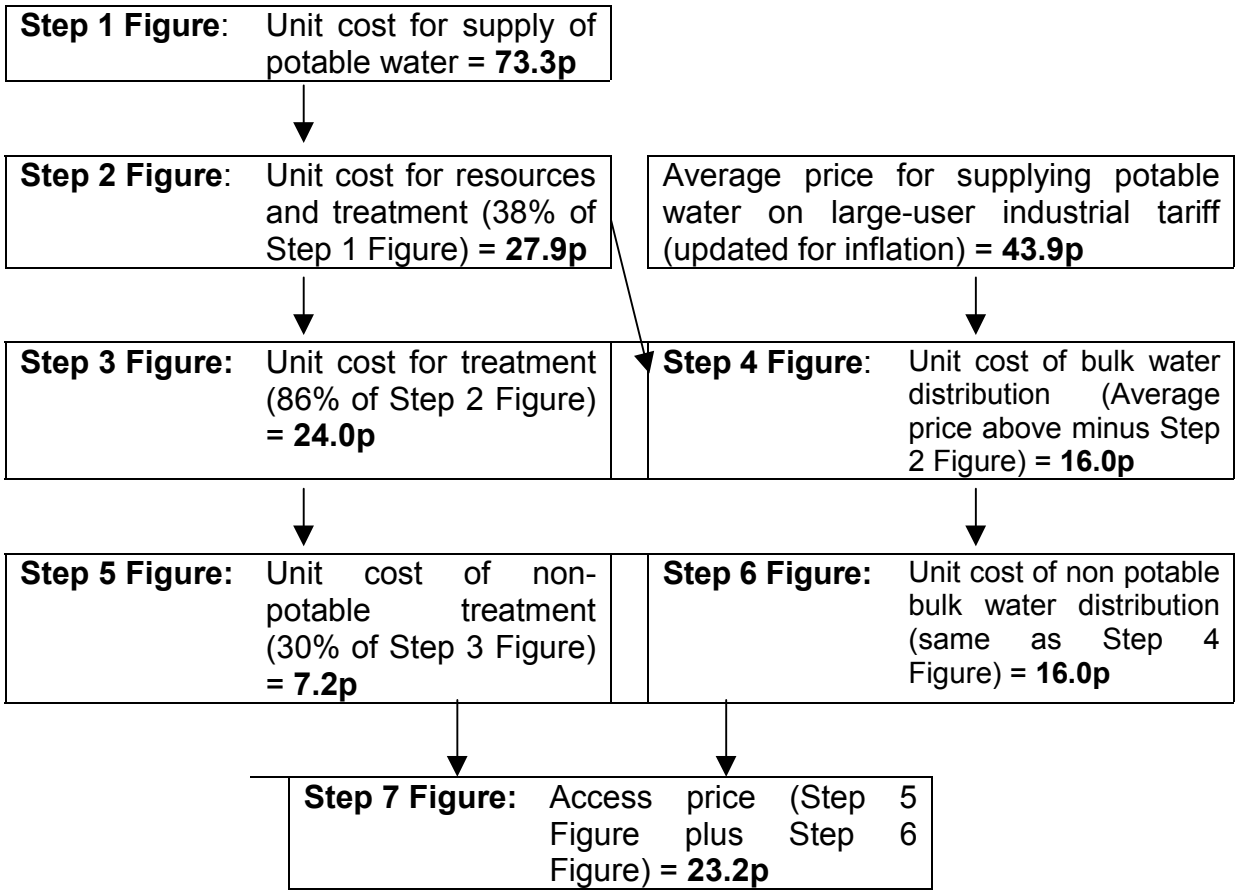
254. Dŵr Cymru used average revenue figures as a proxy for average costs. Without individual specific costs data, when calculating, for example, new tariffs, undertakers have typically used average revenue figures as a reasonable proxy for average costs on the basis that these average revenue figures are regulated under WIA91. The fact that Dŵr Cymru used average revenue figures as a proxy for average costs when calculating the First Access Price is not therefore unusual within the water industry in England and Wales.

255. However, using average revenue figures in this way does raise particular difficulties. First, Dŵr Cymru began with its revenues from both potable and non-potable supplies, and then made an adjustment to reflect the fact that this case involved the treatment and distribution of non-potable water only. It is not straightforward to assess whether these adjustments have allocated costs appropriately (please see our comments on particularly Steps 1, 5 and 6 of Dŵr Cymru's approach to calculating the First Access Price below). Second, the above adjustment to convert a revenue figure based on both potable and non-potable supplies into a figure based only on non-potable supplies, raises the difficult general question of whether further adjustments should be made to the overall calculation to reflect the individual characteristics of a particular case. (We refer in particular to our comments below on whether or not "average" customer service, scientific service and debts/rates related costs should be excluded from Step 1 of Dŵr Cymru's calculation, and whether more specific figures for these costs should be added back at the end of the overall calculation.)

256. Third, using revenue figures as a proxy for costs would be inappropriate if the revenue figures themselves amounted to excessive pricing or contained revenues from activities (such as retail activities) to which the final access price would not relate (without an appropriate adjustment to remove the revenues relating to any such activities at some point in the overall calculation). With regard to the former point, in the absence of any evidence to the contrary, and because the average revenue figures used by Dŵr Cymru as its starting point in the calculation of the First Access Price are regulated under WIA91, we have assumed that these figures do not themselves represent excessive pricing. With regard to the latter point, Albion Water did argue that Dŵr Cymru had inappropriately included "*customer facing costs*" when calculating the First Access Price, as part of its arguments on "price squeezing". We have dealt with these arguments in paragraphs 342 to 352 below.

Calculation of the First Access Price

257. Dŵr Cymru's approach to calculating the First Access Price is summarised in the diagram below.



258. Step 1: Estimate an average unit price for supply of potable water: In Step 1, Dŵr Cymru estimated an average unit price for the supply of potable and non-potable water. Dŵr Cymru began with the total revenue it had received in the financial year 1999/2000, which was the latest year for which there were figures available. Dŵr Cymru then excluded "third party services" (which amounted to £7.1 million) from this figure, to produce net revenue of £220.4 million. "Third party services" are a category of revenues (and costs) referred to in the RAGs. But in this case it appears that the material component of this category was a bulk supply agreement under which Dŵr Cymru supplies Severn Trent Water Limited ("Severn Trent Water") with very significant volumes of water from the Elan Valley ("Elan Valley Bulk Supply Agreement"). "Elan Valley" is the name given to a system of reservoirs, dams and aqueducts that take a very significant volume of water from Dŵr Cymru to Severn Trent Water.

259. Dŵr Cymru then divided the total net revenue of £220.4 million by the total volume of potable and non-potable water it supplied which, excluding certain volumes, amounted to approximately 289,120 Ml (289.12 million m^3) per annum. This produced an average price of 76.2 p/m^3 in 1999/2000 prices. The vast majority of the volumes which were excluded were those from the Second Bulk Supply Agreement and the Elan Valley Bulk Supply Agreement.

260. Dŵr Cymru adjusted this average price to 2000/2001 prices by taking account of inflation plus the 'Water Service Indicative K-factor' (which is a hypothetical price limit given to water and sewerage undertakers as a guide to how they should increase the tariffs for separate water and sewerage services) which together equated to a 3.8% reduction. This produced an average figure which was used by Dŵr Cymru as an average unit cost for potable and non-potable water delivered to domestic and industrial customers of 73.3 p/m^3 ("Step 1 Figure").

261. In its letter of 5 July 2001, Albion Water complained that Dŵr Cymru had excluded the Second Bulk Supply Agreement and the Elan Valley Bulk Supply Agreement from the Step 1 calculation. Albion Water suggested that an appropriate adjustment to include these Agreements would result in the unit price reducing to $50p/m^3$. Albion Water raised a similar argument in its letter of 21 December 2001, although in this letter it indicated that it thought that the **revenues** of the Elan Valley Bulk Supply Agreement had been **included** but the **volumes excluded** from the calculation (in fact both the revenues and the volumes were excluded). It claimed that Dŵr Cymru's approach *"allows the costs associated with the* [Elan Valley Bulk Supply Agreement] *to be included as part of the total regional costs but does not include the volume supplied as part of the divisor necessary to achieve a unit cost per cubic metre."*

262. There does not appear to be any reason why the volumes of the Second Bulk Supply Agreement should be excluded from Step 1. Indeed, it appears counterintuitive to start the calculation of an access price which relates to the costs of treating and distributing water to a particular customer by excluding figures from an existing agreement under which those services are provided. We have seen no evidence that there are any special circumstances relating to the Second Bulk Supply Agreement which would justify excluding it in this way. It is inconsistent to exclude the volumes, but include the revenues, from the same agreement. We therefore think that the Step 1 Figure should be adjusted by adding in the volume figures from the Second Bulk Supply Agreement in the relevant year. In 1999/2000 Shotton received approximately 17 Ml per day (6,205 Ml per annum). This would produce an average unit cost in 2000 prices of 74.6 p/m^3, rather than 76.2 p/m^3. Adjusting the average price to 2001 prices would produce a Step 1 figure of 71.8 p/m^3, rather than 73.3 p/m^3.

263. We also considered the circumstances around the exclusion of the Elan Valley Bulk Supply Agreement. Dŵr Cymru had excluded both the revenues and, contrary to Albion Water's belief in its letter dated 21 December 2001, the volumes from the Elan Valley Bulk Supply Agreement when calculating the Step 1 Figure. In 2001/2002, Dŵr Cymru supplied approximately 122,896 Ml at a price of approximately 3.3 p/m^3 under the Elan Valley Bulk Supply Agreement. The price is adjusted each year by the average change in the cost of water for both companies. Dŵr Cymru also made a conditional sale of the assets relating to the Elan Valley supply to Severn Trent Water at a consideration of £31.7 million[84]. This money was invested in a trust fund, the principal function of which was to provide an income to Dŵr Cymru while protecting the capital value of the fund in real terms. The Elan Valley Bulk Supply Agreement is due to terminate on 31 March 2073, although Severn Trent Water has an option to renew the Agreement before then.

264. The volume of water supplied under the Elan Valley Bulk Supply Agreement is highly unusual. The water is used by Severn Trent to supply its large customer base in the Midlands via infrastructure owned by Severn Trent, following Dŵr Cymru's conditional sale of the assets. It is the highest volume of water supplied by any undertaker under a single agreement. The next highest volume of water supplied by Dŵr Cymru is that supplied under the Second Bulk Supply Agreement (which equates to only about 5% of the volume supplied under the Elan Valley Bulk Supply Agreement).

265. We consider that, in view of the special circumstances in which the assets relating to the Elan Valley supply were financed, the history of that supply and the highly unusual volumes of water supplied, it does not appear to be unreasonable to exclude figures relating to the Elan Valley Bulk Supply Agreement from the Step 1 calculation.

266. Dŵr Cymru's approach to Step 1 of its calculation of the New Tariff is the same as that for the First Access Price, except that, in the case of the New Tariff, customer service, scientific service, and debt/rates related costs were excluded from the total revenue figure, which was Dŵr Cymru's starting point in both calculations.

267. Customer service costs are principally made up of billing and account management costs, and are mainly generated by domestic supplies. They were therefore removed from Step 1 of the calculation of the New Tariff, with a more specific customer service cost being added back at the end of the overall calculation.

268. The same approach was followed for scientific service costs, which relate to, for example, checking water quality. Although the position is much less clear cut than for customer service costs, more of these costs might well relate to domestic supplies (where water must be checked regularly for potability) than relate to non-potable supplies.

269. A figure for costs relating to debts and rates was also excluded from Step 1 of the calculation of the New Tariff, and a figure added back at the end of the calculation. This was because it was difficult to see how these costs were directly driven by the individual elements which underpinned the cost allocations in Steps 2 to 7. Rather than have these costs "diluted" by cost allocations which were decided for reasons which were not related to how these particular costs should be apportioned, Dŵr Cymru thought it more appropriate to exclude them from Step 1 and add them back later.

270. It might be argued that including, in particular, customer service costs in Step 1 of the First Access Price calculation was inappropriate. However, in any calculation based on average figures, there are difficult questions about when, if at all, to include (or exclude) more specific figures. Scientific service costs are not straightforward to calculate on a specific basis. Also, excluding the three costs identified above from Step 1 of the First Access Price calculation and adding back specific figures at the end of the calculation would cause the particular difficulties for the calculation of the First Access Price because of Dŵr Cymru's particular approach to Step 4. These difficulties are explained below.

271. In Step 4 of both the First Access Price and the New Tariff, Dŵr Cymru estimated the unit cost for bulk water distribution. In Step 4 of the New Tariff, (but not in Step 4 of the First Access Price) Dŵr Cymru used the distribution element of the Step 1 Figure (which is produced by Step 2) as its starting figure. As the three costs referred to above had been excluded from the Step 1 Figure when calculating the New Tariff, this starting figure used in the New Tariff calculation did not contain any customer service, scientific service, or debt/rates related costs. There was therefore no problem with adding back more specific figures for these costs at the end of the New Tariff calculation.

272. In contrast, in Step 4 of the First Access Price, Dŵr Cymru used a different starting figure, by first calculating the average price it charged for supplying water to its "large user" customers on its large industrial tariff (please see our comments on Step 4 below). This figure **does** contain the three costs referred to above. Consequently, if these costs were to be added back at the end of the whole calculation this would result in some "double counting" of customer service, scientific service and debt/rates related costs. To avoid this, the element of the average price charged by Dŵr Cymru for supplying water to its "large user" customers on its large industrial tariff which corresponded to these three costs would have to be removed. It is not clear exactly what this element would amount to.

273. In addition, the parties may have different views about the level of specific costs to be added back at the end of the calculation. Finally, we note that removing the relevant costs from Step 1 and adding them

back later might increase the First Access Price, depending on exactly what specific figures are added back. This is because when these costs are retained in Step 1 of the calculation, the remaining Steps "dilute" them (which does not happen if the costs are added back at the end).

274. In light of the above, we have not therefore made any adjustment to the overall calculation by taking out these three costs at Step 1, and adding them back later.

275. Step 2: Apportion this unit cost between resources/treatment and distribution: In Step 2, Dŵr Cymru apportioned the Step 1 Figure between resources and treatment activities on the one hand (38% of the unit cost) and distribution activities on the other hand (62% of the unit cost), based on its regulatory accounts. Dŵr Cymru therefore estimated a unit cost for resources and treatment of 27.9 p/m^3. This is referred to as the "Step 2 Figure".

276. In calculating the New Tariff, Dŵr Cymru made a similar apportionment. The split was 41% of the unit cost for resources and treatment activities and 59% for distribution activities. The two apportionments are very similar, and the small differences between the two are the result of minor differences in the presentation of its accounts by Dŵr Cymru over the relevant period. We do not believe that Dŵr Cymru's apportionment of the Step 1 Figure in this Step of the calculation of First Access Price was unreasonable. (With our adjustment to the Step 1 Figure set out above, the Step 2 Figure would reduce to approximately 27.3 p/m^3. Please see Table 1 below.)

277. Step 3: Separate resources and treatment elements: In Step 3, Dŵr Cymru separated the "Step 2 Figure" into resource activities (14% of the total unit cost) and treatment activities (86% of the total unit cost). Dŵr Cymru therefore estimated a unit cost for treatment of 24.0 p/m^3 (the "Step 3 Figure").

278. Albion Water argued that the apportionment of costs between resources and treatment in Step 3 was vastly different from the same apportionment done in a report prepared by Dŵr Cymru in July 1996 in connection with the bulk supply negotiations between Dŵr Cymru and Albion Water (which were linked to Albion Water's application for an Inset Appointment). As part of these negotiations, Dŵr Cymru assessed how it would calculate a non-potable tariff (which it did not then offer). In this report, Dŵr Cymru based a non-potable tariff calculation on 1994-95 regulatory accounts. However, the report identified resources costs (including abstraction charges) of approximately £11 million per annum, and treatment costs of approximately £50 million per annum. The split between resources and treatment activities was therefore 82% (treatment) and 18% (resources). Contrary to Albion Water's belief that this split was vastly different from that used in Step 3, it was in fact broadly equivalent to

Dŵr Cymru's split in Step 3 of 86% (treatment) and 14% (resources) which was based on information from 1999/2000.

279. However, in calculating the Step 3 Figure, Dŵr Cymru had allocated the vast majority of the operating and depreciation costs of resources and treatment activities to the treatment activity, on the basis of its management accounts. We believed that too many of these operating and depreciation costs had been allocated to the treatment activity. In particular, charges which Dŵr Cymru has to pay to the EA for the right to abstract water from rivers were largely allocated to treatment, rather than to resources (which would be more appropriate). As part of our review of the New Tariff, Dŵr Cymru agreed that these costs actually related entirely to the resources activity. The New Tariff is based on the assumption that only 77% of the unit price of water resource and treatment activities relate to treatment activities, with 23% relating to water resource activities. We therefore think it would be more appropriate to apportion the Step 2 Figure in this way. Together with our adjustment in the Step 1 Figure discussed above, this would produce a unit price of treatment activities of 21 p/m^3 (i.e. 77% of the Step 2 Figure), rather than the original Step 3 Figure of 24 p/m^3 calculated by Dŵr Cymru. The Step 3 Figure re-enters the calculation at Step 5 (please see below).

280. Step 4: Estimate the unit cost for bulk water distribution: In Step 4, Dŵr Cymru estimated the unit cost for bulk water distribution. It had calculated the treatment element of the First Access Price separately (please see Steps 1, 2, 3 and 5). In the final Step of the overall calculation (Step 7), Dŵr Cymru would simply add the treatment and distribution elements to produce the First Access Price.

281. As discussed above, in calculating the distribution element in this Step 4, Dŵr Cymru did not start from the distribution figure generated by Step 2 (which is what it did when calculating the New Tariff). Instead, it used a different starting point, by first calculating the average price it charged for supplying potable water to its "large-user" customers on its large industrial tariff (45.6 p/m^3). This figure was then adjusted to 2000/01 prices by taking account of inflation plus the Water Service Indicative K-factor (i.e. the same adjustment to the one it made when adjusting prices to 2000/01 prices in calculating the Step 1 Figure) to give a figure of 43.9 p/m^3.

282. Large users take large volumes of water and, since they generally use large pipes, cost less to supply than domestic and small non-domestic customers, which also use the smaller diameter local distribution network. The large industrial tariffs reflect this, and so it appears Dŵr Cymru saw this as an appropriate basis for estimating a bulk distribution cost for a large user.

283. This figure of 43.9 p/m^3, derived from Dŵr Cymru's large industrial tariff, obviously contained a charge for resources and treatment. Dŵr

Cymru therefore calculated the unit cost for bulk water distribution on its own by subtracting the unit cost of resources and treatment from Step 2 (27.9 p/m^3) from the average cost of supplying large users (43.9 p/m^3) to give 16.0 p/m^3 (the "Step 4 Figure").

284. Our adjustment to the Step 2 Figure discussed above would have an impact on the Step 4 Figure, increasing it from 16 p/m^3 to 16.6 p/m^3 [85]. In simple terms, a reduction in the Step 2 Figure means that a lower figure is deducted from the large industrial tariff in Step 4, which results in a higher Step 4 Figure. However, Dŵr Cymru's large industrial tariff relates only to potable water, whereas the amount deducted by Dŵr Cymru for resources and treatment (produced by Step 2) includes both potable and non-potable supplies. We had concerns about this inconsistency in Dŵr Cymru's approach, which appears to compromise that approach.

285. In contrast, Dŵr Cymru's starting point when calculating the distribution element of the New Tariff was the unit cost for distribution activities produced by Step 2. Dŵr Cymru then estimated that bulk supplies accounted for 35% of this figure (with the small diameter local distribution network accounting for the remaining 65%). If hypothetically Dŵr Cymru had taken the same approach to calculating the Step 4 Figure for the First Access Price as it did for the New Tariff, it would have calculated 35% of the distribution figure generated by Step 2 (which with our adjustments would be 44.5 p/m^3). The resulting figure for distribution would have been 15.6 p/m^3. However, any apparent reduction in the distribution element of an access price calculated in this way might be offset by an increase in the final access price resulting from the removal of certain costs at the beginning of Step 1 and their reinsertion at the end of the calculation, which means that it would not be appropriate to simply adjust the distribution element of the First Access Price down to this figure of 15.6 p/m^3.

286. Rather, in order to assess whether an adjustment should be made to Step 4 in the calculation of the First Access Price, we analysed costs justifications provided by Dŵr Cymru for its then new large industrial tariffs in November 1998. These provided evidence that distribution costs associated with Dŵr Cymru's bulk supplies equated to approximately 35.5% of Dŵr Cymru's total distribution costs. If the distribution element of the First Access Price were assumed to be 35.5% of Dŵr Cymru's total distribution costs of 44.5 p/m^3 (as produced by Step 2, with our adjustments), the resulting distribution element would be approximately 15.8 p/m^3. (The 16 p/m^3 distribution element of the First Access Price advanced by Dŵr Cymru represents approximately 36% of Dŵr Cymru's total distribution costs of 44.5 p/m^3).

287. In light of the above, we conclude that a figure of 16.6 p/m^3 would be inappropriate, because this figure would not take account of the apparent inconsistency arising from the fact that Dŵr Cymru's large

industrial tariff relates only to potable water, whereas the amount deducted for resources and treatment (produced by Step 2) includes both potable and non-potable supplies. It would also not be appropriate to simply reduce the distribution element of the First Access Price to 15.6 p/m^3. The costs justifications Dŵr Cymru provided for its then new large industrial tariffs in November 1998 point to a figure of approximately 15.8 p/m^3. The figure of 16 p/m^3 (representing approximately 36% of Dŵr Cymru's total distribution costs of 44.5 p/m^3) is sufficiently close to this figure of 15.8 p/m^3 (representing approximately 35.5% of Dŵr Cymru's total distribution costs of 44.5 p/m^3) that we consider it is not appropriate to make any adjustment to this Step of the calculation of the First Access Price. Nonetheless, we are disappointed to have found apparent inconsistencies in the methodology used by Dŵr Cymru in Step 4.

288. On a separate point, Albion Water also argued that the calculation of the First Access Price inappropriately included in the Step 1 Figure an element of leakage expenditure, which Albion Water argued was not wholly relevant to non-potable supplies and, as such, was inconsistent with MD 162[86]. Albion Water did not explain what it meant by "leakage expenditure". It might have related to the costs involved in monitoring leakage and loss of water. Similarly, Albion Water did not explain why it believed Dŵr Cymru's approach to be inconsistent with MD 162. MD 162 states that, where an incumbent water company granting common carriage access requires entrants "to include an amount of water leakage, additional to the water taken to their customers, then the most appropriate figure would be the incumbent company's economic level of leakage appropriate to the part of the system involved". It appears that Albion Water considered this supported its view that the appropriate amount of leakage expenditure would also vary depending on the part of the system involved.

289. The vast majority of leakage expenditure is incurred in relation to local networks involving smaller pipes rather than larger bulk supply pipes, such as the Ashgrove System. This is because leaks on larger pipes delivering larger amounts of water are more obvious and so, in general, require less monitoring. However, Dŵr Cymru informed us that, in practice, it operates an integrated system and does not distinguish between different types of pipe when monitoring the system. Dŵr Cymru's calculation of the Step 4 Figure starts with its large industrial tariff, which already recognises the difference between bulk and local distribution charges and therefore takes into account any reduction in leakage expenditure appropriate to bulk supplies. Any difference in the leakage expenditure of bulk potable and bulk non-potable supplies is likely to be minimal.

290. Step 5: Estimate the unit cost of non-potable treatment: In Step 5, Dŵr Cymru estimated the unit cost of non-potable treatment, by adjusting the Step 3 Figure (which was the unit cost of both potable and non-potable treatment). Generally, the cost of non-potable treatment is

likely to be lower than that of potable treatment because potable water has to be treated to a higher standard. In calculating the First Access Price, Dŵr Cymru estimated that non-potable treatment only represented 30% of the Step 3 Figure, giving a unit cost of non-potable treatment of 7.2 p/m^3 (the "Step 5 Figure").

291. Albion Water said that the whole company average methodology used by Dŵr Cymru apportioned current income using unsupported percentages, which did not reflect direct costs or the specific service at issue. Albion Water argued that Dŵr Cymru's assumption that the costs of treatment for non-potable water were 30% of the costs of treatment for potable water was *"unsubstantiated, there is no audit trail, and on any reasonable engineering assessment the assumed cost is excessively high"*. Albion Water claimed that Dŵr Cymru's estimated cost of treatment for non-potable water (30% of that of potable water costs) was not relevant to the treatment actually carried out by Dŵr Cymru in this case which Albion Water considered to be minimal.

292. Albion Water argued that the treatment cost component of Dŵr Cymru's calculation was inconsistent with information in Dŵr Cymru's Scheme of Charges for 2003/2004. Albion Water pointed out the difference of 3.88 p/m^3 between Dŵr Cymru's partial treatment and raw water tariffs (which implied the cost of partial treatment was 3.88 p/m^3). In Albion Water's view this represented the maximum possible treatment costs for this class of customer (although Albion Water did not specify which class of customer) and, it alleged, provided proof that Dŵr Cymru had made conflicting statements to Ofwat about the real costs involved. Albion Water therefore believed that it had been deliberately overcharged. Albion Water also noted that it had consistently argued that Albion Water's own assessment of treatment costs would be nearer to 3 p/m^3 (based on what Albion Water considered to be the direct costs of treatment at the Ashgrove Treatment Works).

293. Dŵr Cymru's assumption that non-potable treatment represented 30% of the Step 3 Figure was based on average cost calculations and was not specific to the Ashgrove System. Some non-potable sources need minimal treatment, but others require more expensive treatment. Albion Water has now accepted[87] that access prices can be based on average regional costs (rather than, in this case, the direct costs of treating water at the Ashgrove Treatments Works). We have not therefore investigated the direct costs of treatment at the Ashgrove Treatment Works.

294. As part of its work on the New Tariff, Dŵr Cymru reviewed its assumption of the split between potable and non-potable treatment costs by examining the treatment costs incurred at 11 treatment works of a comparable size and capacity to the Ashgrove Treatment Works. On the basis of this new work, Dŵr Cymru considered that non-potable treatment costs should be assumed to be 15.2%, rather than 30%, of

potable treatment costs, and the New Tariff was calculated on this basis. We were surprised by this reduction in the percentage as our initial view was that the original 30% figure might in fact have been a low estimate because, for example, treatment works like the Ashgrove Treatment Works appear to be relatively sophisticated, as they involve chemically assisted settlement. However, although the 11 treatment works considered are still only a sample, this new work clearly indicates that that 15.2% would be a more appropriate figure in this Stage 5 of the First Access Price calculation. We therefore think that an appropriate adjustment should be made. With this adjustment (together with the adjustments to Steps 1 and 3 discussed above), the Step 5 Figure would be reduced from 7.2 p/m^3 to 3.2 p/m^3.

295. This figure broadly matches Albion Water's assessment of the direct costs of treatment at the Ashgrove Treatment Works, and is below Albion Water's estimate of maximum possible treatment costs. Ultimately, it is this adjustment to Step 5 of the calculation which most significantly affects the First Access Price.

296. There was, however, no evidence that Dŵr Cymru had deliberately overestimated the non-potable treatment costs as Albion Water alleges. In fact, it was Dŵr Cymru itself that highlighted the case for a lower percentage in Step 5 following its own further work in the context of the New Tariff.

297. Step 6: Estimate the unit cost of non-potable bulk water distribution: In Step 6, Dŵr Cymru estimated the unit cost of non-potable bulk water distribution. It assumed that the cost of transporting non-potable water in bulk was the same as the cost of transporting potable water. Dŵr Cymru therefore concluded that the unit cost of non-potable bulk water distribution (the "Step 6 Figure") was the same as that for potable water (i.e. the Step 4 Figure of 16.0 p/m^3).

298. Albion Water argued that Dŵr Cymru had: *"[pooled] the low costs associated with non-potable bulk transport with the much higher costs associated with bulk potable transport in order to manufacture an artificially high access price […]"*.

299. In a meeting between Dŵr Cymru and Ofwat officials, Dŵr Cymru argued that it regarded its network as an integrated system, although it recognised that there were non-potable pipes within its overall system that were discrete. Dŵr Cymru argued that a pipe was a pipe, irrespective of what it is carrying. Dŵr Cymru drew our attention to the Operation Services Agreement between Dŵr Cymru and its operating partner, United Utilities Operating Services, which sets out the terms under which the water supply services are operated and maintained, and which makes no distinction between the costs associated with potable and non-potable mains. They are simply referred to as "trunk mains", irrespective of whether they are transporting potable or non-potable water.

300. The main cost drivers for transporting water though pipes are linked to the size (diameter) and the material and smoothness of the pipe, required flow rate, distance, direction and change in altitude between the points at which the water enters and leaves the pipe. These cost drivers are largely independent of the quality of the water being transported.

301. In practice, the differences in the physical characteristics (density and viscosity) of partially treated non-potable water and potable water would be minimal in so far as they could directly affect the costs of water distribution. It does not therefore appear that the cost of transporting a given volume of water is fundamentally affected by whether the water is potable or non-potable.

302. We do not therefore believe that Dŵr Cymru was unreasonable to assume that the cost of transporting non-potable water in bulk was the same as the cost of transporting potable water. (Albion Water also questioned the distribution element of the First Access Price on the basis of its interpretation of the RAGs. This is discussed below, and does not affect our conclusion on Step 6).

Step 7 – Estimate access price

303. In Step 7, Dŵr Cymru calculated the First Access Price by adding the Step 5 Figure (the unit cost of non-potable water treatment) to the Step 6 Figure (the unit cost of non-potable water distribution). This produced the First Access Price of 23.2 p/m^3. Dŵr Cymru took a similar step at the end of its calculation for the New Tariff, except that it also added back specific costs for customer services, scientific services, and debt/rates costs. But with our adjustments to Steps 1, 3 and 5, the First Access Price would be 19.2 p/m^3 – 4 p/m^3 lower. The vast majority of the 4 p/m^3 reduction results from the adjustment in Step 5.

304. A summary of Dŵr Cymru's calculation of the First Access Price, the three adjustments referred to above, and the effect of those adjustments on the First Access Price is set out in Table 1 below.

Table 1: Impact of Ofwat Adjustments on the First Access Price
The adjustment in Step 5 assumes that the adjustment in Step 3 has already been made. The figures in the right hand column all take account of any changes made higher up in the calculation.

Figure	**First Access Price (p/m^3)**	**Ofwat Adjustments**	**First Access Price with Ofwat Adjustments (p/m^3)**

Step 1 Figure (unit cost for supply of potable water)	73.3	Volumes of the Second Bulk Supply Agreement should be included	71.8
Step 2 Figure (unit cost for resources and treatment)	27.9	None	27.3
Step 3 Figure (unit cost for treatment)	24	Step 2 Figure should be apportioned 77% (not 86%) to treatment, and 23% (not 14%) to resources	21
Step 4 Figure (unit cost of bulk water distribution)	16	None	16
Step 5 Figure (unit cost of non-potable treatment)	7.2	Assumption should be that non-potable treatment is 15.2% (not 30%) of the Step 3 Figure	3.2
Step 6 Figure (unit cost of non-potable bulk water distribution)	16	None	16
Step 7 Figure (First Access Price)	23.2	None	19.2

Summary of adjustments to the First Access Price

305. The adjustments to Steps 3 and 5 referred to above are reflected in Dŵr Cymru's approach to the New Tariff. Although the methodologies which underpin the First Access Price and New Tariff are still slightly different (certain costs are removed from Step 1 of the New Tariff calculation, and put back at the end of the calculation), the New Tariff contains a treatment and distribution element which is broadly consistent with the First Access Price, once our adjustments have been taken into account. The New Tariff (which is the tariff which would apply to Shotton if it were to become a customer of Dŵr Cymru again in 2004/2005) is approximately 26.6 p/m[388], of which approximately 6.8 p/m^3 relates to resource activity. The New Tariff therefore appears to contain a treatment and distribution element (together with common costs) of approximately 20 p/m^3; the First Access Price, with our adjustments, would be 19.2 p/m^3.

306. In turn, Dŵr Cymru's Second Access Price appears to be similar to the New Tariff (and thus with the First Access Price, with our adjustments), in certain key aspects. The Second Access Price consists of treatment costs of 3.31 p/m^3 and distribution costs of 14.43 p/m^3, but does not include "*other administrative and associated costs*". The treatment and distribution cost elements are the same as those contained in the New

Tariff. Dŵr Cymru did not quantify exactly what the "*other administrative and associated costs*" would be in the Second Access Price in this particular case (and we have not considered whether the Second Access Price itself might amount to the abuse of a dominant position by Dŵr Cymru). But they might cover customer services, scientific services, and debt/rates costs (which are added back at the end of the New Tariff calculation).

307. In summary, we consider that three adjustments should be made to the calculation of the First Access Price. With these adjustments, the First Access Price would be reduced from 23.2 p/m^3 to 19.2 p/m^3.

Consistency with Regulatory Accounting Guidelines

308. Albion Water also argued that Dŵr Cymru's approach to calculating the distribution element of the First Access Price was inconsistent with the RAGs. In its letter of 25 February 2002, referring to the RAGs[89], Albion Water said:

"Ofwat's Regulatory Accounting Guidelines and [June Return] *reporting rules are very clear. These state that all costs associated with the transport of non-potable water should be included in the category of water resources and excluded from the bulk transport of treated water (RAG4 3.2.4). These rules have not been applied by Dŵr Cymru, which has used bulk potable water transport charges as the basis for charges to non-potable mains. This is not the service sought. On a regional average basis Dŵr Cymru charges itself raw water transport costs which must be a proportion of the acknowledged water resource costs of 3.9p/m^3 (estimate for raw water transport 0.7p/m^3). Transport costs for non-potable water cannot be 16p/m^3 as claimed by Dŵr Cymru"*

309. Similarly, Albion Water argued in the Annex to its 12 August 2003 letter that:

"As your own RAG rules clearly state, distribution costs for non-potable water fall into water resource costs and must be explicitly excluded from potable distribution costs. Dŵr Cymru has used potable distribution costs as a proxy for non-potable distribution costs."

310. The RAGs are produced by Ofwat and set out the principles to be followed by water companies when preparing their regulatory accounts. RAG4 covers the form, content and principles to be used in analysing operating costs and assets. One of the objectives of RAG4 is to ensure consistency amongst water companies. RAG2 covers the classification of expenditure by purpose category.

311. Albion Water's argument relating to the RAGs is not entirely clear. However, it appears that, based on its own interpretation of the RAGs,

Albion Water believes that all costs attributable to transporting non-potable water, such as the water supplied to Shotton, are included in the figure allocated to water resources in Dŵr Cymru's regulatory accounts.

312. On this basis, Albion Water believes that the amount Dŵr Cymru should charge Albion Water for the transport of water through the Ashgrove System should be less than the amount Dŵr Cymru pays United Utilities Water for the water resource under the First Bulk Supply Agreement. Albion Water indicates in its letter of 25 February 2002 that it believes the cost of the water resource to be 3.9p/m^3. (United Utilities has informed us that the fee charged to Dŵr Cymru for the water has historically been broadly equivalent to around 3 p/m^3. In this regard, see paragraph 65 above.) Albion Water therefore alleges that the figure of 16p/m^3 allocated by Dŵr Cymru is incorrect.

313. Albion Water's summary of RAG4 is incorrect. It appears that Albion Water has confused the expressions "raw water" and "non-potable" water. As explained above, non-potable water can be either raw water or water which has undergone some treatment but is not suitable for drinking (i.e. partially treated water). RAG4 refers to both raw water and non-potable water in different contexts, which may be the source of Albion Water's apparent confusion. Nevertheless, it is clear that the water supplied by Dŵr Cymru to Albion Water is not raw water because it undergoes treatment at the Ashgrove Treatment Works. It is therefore correct to classify this water as non-potable in this context.

314. RAG4 3.2.4 does not state that *"all costs associated with the transport of **non-potable** water should be included in the category of water resources"* (emphasis added), as maintained by Albion Water in its letter dated 25 February 2002. RAG4 3.2.4 actually states that *"All direct costs associated with the abstraction, conveyance and treatment of **raw** water […]"* (emphasis added) should be included under the heading "Water Resources and Treatment". It specifically states that the functional costs of **non-potable** water should be excluded from this category. RAG4 3.2.7 makes it clear that the costs of producing and delivering non-potable water should be included in third party services costs.

315. RAG2 supports the conclusion that the cost of transporting the water to Shotton is not included in the cost of the water resource. Under RAG2, water distribution mains include *"all mains associated with the supply of water for industrial and domestic use […]"*. This reflects the actual use (or purpose) of the pipes, that is they are used to deliver water to a customer's site. RAG2 states that water resource facilities costs include *"all mains or aqueducts associated with the transfer of raw water either between sources or from source to treatment".*

316. Consequently, the premise on which Albion Water's argument is based is incorrect. (Albion Water made two further arguments that the First

Access Price was too high based on its interpretation of the RAGs set out above. But as this interpretation is incorrect, those arguments are not sustainable.)

Efficient Component Pricing Rule (ECPR), the Costs Principle, and the Second Bulk Supply Agreement

317. Dŵr Cymru's method of calculating the First Access Price depends on cost allocation assumptions. In the absence of individual costs data in the water industry in England and Wales (such as the direct costs of treating and distributing water for particular customers), there will always be a certain degree of uncertainty about what assumptions to make (and what, if any, misallocation of costs there has been, when analysing these assumptions). For example, in Step 5 of the calculation of the First Access Price further work by Dŵr Cymru suggested that a different cost allocation should be made from the one originally made.

318. We therefore think that there are dangers in accepting only one approach when assessing costs and whether or not an access price is excessive, even where that approach has been adopted by the company being investigated. When approving tariffs under the annual WIA91 tariff approval process, we examine proposed tariffs from a number of different perspectives. The Telecommunications Notice states that, "*In certain circumstances, where comparative data are not available, regulatory authorities have sought to determine what would have been the competitive price were a competitive market to exist. In an appropriate case, such an analysis may be taken into account by the Commission in its determination of an excessive price*". 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 that the Costs Principle would generate.

319. We have also considered ECPR. Although it was not used by Dŵr Cymru, it is one of the alternative methods for calculating access prices we considered in our guidance on common carriage access codes. It is also relevant because, as noted in paragraph 244 above, the Costs Principle in section 66E WIA91 provides for a retail-minus approach to setting access prices, and ECPR is the approach most often considered when "retail minus" is discussed. As the Costs Principle is itself a retail minus approach, we have considered ECPR first.

320. The use of ECPR as a method of calculating access prices has been a large part of regulatory economics literature in the last decade. Discussion has usually taken place in the context of competition in network industries such as rail, telecommunications and electricity. There has been little discussion of ECPR or other access pricing rules specifically in the context of competition in providing water supplies. However, the use of ECPR as a method of calculating access prices is

supported by research undertaken by National Economic Research Associates ("NERA"), an economics consultancy. NERA wrote two reports on access prices for Northumbrian Water, in 2000[90] and 2001[91]. These reports represent an economic evaluation of the basis for setting access prices in the water industry in England and Wales. Both the NERA reports supported the use of ECPR, compared with other approaches for setting access prices, as the way to promote competition in the water industry in England and Wales.

321. In the 2000 report NERA states[92]:

"We conclude that in the current circumstances of the UK water industry ECPR is more appropriate as a basis for setting access charges than an approach where prices are centred on Long Run Marginal Cost (LRMC). This is because in our view in the early stages of competition ECPR is more likely to lead to access prices that reflect the need to cover total costs, is more likely to avoid inefficient entry, and is more likely to allow companies to meet existing customer service obligations and to limit the possibility of "cream skimming" that would put pressure on companies to unwind existing regionally averaged retail tariff structures".

322. In its 2001 report, NERA discusses the appropriateness of setting access charges using the ECPR for the water industry in England and Wales. It concludes[93] that

"… under current circumstances, ECPR should be the favoured methodology for setting access charges in the [England and Wales] *water industry in a pro-competitive manner."*

323. Access prices calculated under an ECPR approach may be perceived as being more favourable to undertakers than prices derived from other approaches, including some alternative retail-minus approaches. This is because ECPR allows the undertaker to produce prices that fully compensate it for the net losses that it would incur when providing a common carriage or wholesale distribution service, as compared with continuing to supply the final customer itself.

324. The Costs Principle under WA03 is also a type of "retail-minus" approach to access pricing. WA03 amended WIA91 to extend the opportunities for competition in the water industry. WA03 includes a specific legal framework for access to the public supply system within the water industry in England and Wales. All water undertakers are given specific duties to allow new water supply licensees to put water into undertakers' networks for onward sale to customers. The new provisions also set out the type of costs of so doing that undertakers are allowed to recover. This is set out in the "Costs Principle". Water undertakers will be required to set their access[94] prices in accordance with the Costs Principle:

"(1) The costs principle […] is that the charges payable by a licensed water supplier to a water undertaker, under the agreement or determination [. . .] shall enable the undertaker to recover from the supplier-

(a) any expenses reasonably incurred in performing any duty under sections 66A to 66C above in accordance with that agreement or determination, and

(b) the appropriate amount in respect of qualifying expenses and a reasonable return on that amount,

to the extent that those sums exceed any financial benefits which the undertaker receives as a result of the supplier supplying water to the premises of relevant customers.

(2) In subsection (1) above, "qualifying expenses" means expenses (whether of a capital nature or otherwise) that the water undertaker has reasonably incurred or will reasonably incur in carrying out its functions.

(3) For the purposes of subsection (1)(b) above, the appropriate amount is the amount which the water undertaker –

(a) reasonably expected to recover from relevant customers; but

(b) is unable to recover from those customers as a result of their premises being supplied with water by the licensed water supplier.

4. Nothing in subsection (3) above shall enable a water undertaker to recover any amount –

(a) to the extent that any expenses can be reduced or avoided; or

(b) to the extent that any amount is recoverable in some other way (other than from other customers of the undertaker).

5. In this section "relevant customers" means customers to whose premises the licensed water supplier is to make any supply of water in connection with which the agreement or determination mentioned in subsection (1) above is made"[95].

325. The Costs Principle therefore sets the parameters for calculating access prices. It describes the revenue relating to certain relevant costs and returns that water undertakers can recover from licensed water suppliers. This includes the direct costs of providing access, such as capital costs incurred in order to give access, and the expenses the undertaker incurs in performing its statutory functions that it would otherwise have recovered from the customers who have switched supplier. This may include, for example, costs related to stranded assets[96].

326. The Costs Principle also describes some costs and returns which water undertakers cannot recover. Any costs that the water undertaker can reduce, avoid or recover in some other way (other than from customers

of the undertaker) cannot be included in the access charge. For example, where the licensee treats its own source of water before putting it into the undertaker's network, the undertaker would treat less water and therefore avoid some power and chemical costs associated with treatment.

327. The "retail-minus" approach to access pricing in the Costs Principle is consistent with the objectives the Government set out in the public consultation[97] that preceded WA03. In support of the Costs Principle, Elliot Morley, Minister for Environment and Agri-Environment stated[98]:

> *"We do not want to encourage people to compete who do not take a fair share of the infrastructure costs, because that would mean there were more costs on existing customers, who do not benefit from the competition. That is reflected in section* [66E of WIA91 (as amended by WA03)], *whereby licensees can enter if they can do things more cheaply than the current undertaker, which puts the onus on them to demonstrate their efficiency. A cost-plus[99] system would allow inefficient entry into the market; there would be less emphasis on the need for efficiency because there would be an element of protection."*

328. Using a "cost-plus" methodology could, in theory, produce the same access prices as a retail-minus approach would produce provided certain restrictive assumptions hold. But in practice the two methods are likely to have different types of errors in the way costs are apportioned. A cost-plus methodology is more likely to lead to errors of exclusion (leading to a lower access price), whereas a retail-minus methodology is more likely to lead to errors of inclusion (leading to a higher access price).

329. When considering any retail-minus approach, it is necessary to take the appropriate retail price, as a starting point. In this case, the appropriate retail price is that contained in the Second Bulk Supply Agreement at the time Albion Water made its complaint against Dŵr Cymru (i.e. 2000/2001), as Albion Water had effectively become Dŵr Cymru's customer in place of Shotton itself. This price in 2000/2001 was 25.8p/m^3. Although we did not formally determine the price in the Second Bulk Supply Agreement, the parties agreed exactly the same price (26 p/m^3) we indicated that we would be minded to determine, if we were required to do so[100].

330. Under a "retail-minus" approach, the access price would be 25.8p/m^3 minus the avoidable costs of resources. These avoidable costs would be the specific costs attributable to the assets used to supply the customer (in this case, the water supplied by United Utilities Water from the Heronbridge Abstraction Point to Dŵr Cymru under the First Bulk Supply Agreement).

331. As noted in paragraph 65, historically Dŵr Cymru has paid approximately 3 p/m^3 for the relevant water under the First Bulk Supply Agreement. In 2000/2001, the price was 3.3 p/m^3. The access price resulting from an ECPR calculation would therefore have been approximately 22.5 p/m^3 (i.e. the retail price of 25.8 p/m^3 minus avoidable costs of approximately 3.3 p/m^3). We think that the Costs Principle would produce the same access price. The difference between this price and the First Access Price of 23.2 p/m^3 is very small: in percentage terms, it is only 3% of the First Access Price[101].

Conclusions on excessive pricing

332. In paragraph 234 above, we said we would consider three questions when assessing whether or not the First Access Price is excessive. The first of these was whether Dŵr Cymru misallocated any costs when calculating the First Access Price.

333. As mentioned above, MD 163 specifically refers to the AAC method as a possible approach to calculating access prices. Dŵr Cymru based its First Access Price on an AAC method (or as it called it a *"whole company average basis"*). Nonetheless, we have found some aspects of Dŵr Cymru's methodology to be unusual and, in some cases, we have found it difficult to understand the reasoning behind a particular approach. For example, it is not clear why Dŵr Cymru apparently chose to omit the volumes of the Second Bulk Supply Agreement when calculating the Step 1 Figure, when this Agreement covers the very supply to which the First Access Price related, and the relevant revenues were included. Similarly, it is not clear why, in Step 4, Dŵr Cymru chose to deduct a potable **and non-potable** resources and treatment figure from a **potable** transport, resources and treatment figure to produce its estimated cost of bulk transport.

334. We consider that three adjustments are necessary to address misallocation of costs in the calculation of First Access Price. First, the volumes of the Second Bulk Supply Agreement should have been included in the Step 1 calculation. Second, the Step 3 Figure should have been based on the assumption that only 77% (rather than 86%) of the unit price of water resource and treatment activities related to treatment activities, with the remaining 23% (rather than 14%) relating to water resource activities. Third, on the basis of further work carried out by Dŵr Cymru (in the context of the New Tariff) since it offered the First Access Price, we believe that the Step 5 Figure should be calculated on the assumption that non-potable treatment represents only 15.2% (rather than 30%) of the Step 3 Figure. The answer to our first question in paragraph 330 above is therefore that we believe Dŵr Cymru did misallocate costs when calculating the First Access Price in the way it did. As the Telecommunications Notice observes, "*Improper allocation of costs and interference with transfer pricing could be used as mechanisms for disguising excessive pricing, predatory pricing or a price squeeze*". We accept that in this case the key misallocation of

costs was only identified following further work by Dŵr Cymru (in the context of the New Tariff) on the costs of its treatment works. Despite the large amount of internal Dŵr Cymru papers we have reviewed during this investigation, we have found no evidence that Dŵr Cymru "*knowingly and willingly*"[102] misallocated costs, or intentionally misrepresented costs. Nonetheless the onus was on Dŵr Cymru to allocate its costs appropriately. This is particularly important when, as in this case, the approach to calculating the access price is complex and based on a series of internal judgments, which will require the investment of considerable time on the part of competitors (such as Albion Water) to analyse and challenge.

335. The second question we considered was whether the First Access Price could be said to bear no reasonable relation to the economic value of the service provided, when judged by reference to the difference between the costs actually incurred by Dŵr Cymru and the price charged.

336. There is no legal definition of the "economic value" of a service. In *United Brands*, the ECJ simply referred to examining differences between costs and prices. Similarly, there is no definition of "excessive" in the context of pricing.

337. We have considered how best to assess costs, and whether the First Access price is excessive in relation to those costs. On the one hand, Dŵr Cymru adopted a particular approach to calculating the First Access Price which, with our adjustments to correct cost misallocation, would point to costs closer to 19.2 p/m^3, than the 23.2 p/m^3 of the First Access Price.

338. However, as discussed above, we think that there are dangers in accepting only one approach when assessing costs and whether or not an access price is excessive. We therefore had regard to the Second Bulk Supply Agreement, the Costs Principle, and ECPR. The access price resulting from an ECPR approach based on the Second Bulk Supply Agreement would be approximately 22.5 p/m^3. We think that the Costs Principle would produce the same price.

339. In light of the above, and despite our dissatisfaction with the fact that the First Access Price did contain cost misallocation, we have doubts about whether the First Access Price could be said to bear no reasonable relation to the economic value of the service provided, when judged by reference to the difference between the costs actually incurred by Dŵr Cymru and the price charged.

340. In *Napp* the Tribunal stated that they found, "*it difficult to imagine, for example, this Tribunal upholding a penalty if there were a reasonable doubt in our minds*" and that, "*It is for the Director to satisfy us in each case, on the basis of strong and compelling evidence, taking account of the seriousness of what is alleged, that the infringement is duly proved,*

the undertaking being entitled to the presumption of innocence, and to any reasonable doubt there may be".

341. We are therefore unable to answer our second question in the affirmative, we do not therefore need to address our third question, and we conclude that Dŵr Cymru did not abuse a dominant position in breach of the Chapter II Prohibition by engaging in excessive pricing.

Price Squeezing

Legal Test

342. Price squeezing by a dominant undertaking can be an abuse within the meaning of the Chapter II Prohibition. The Telecommunications Notice provides the following guidance on when a dominant company can be said to be engaging in price squeezing. It states:

"117. Where the operator is dominant in the product or services market, a price squeeze could constitute an abuse. A price squeeze could be demonstrated by showing that the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company. A loss-making downstream arm could be hidden if the dominant operator has allocated costs to its access operations which should properly be allocated to the downstream operations, or has otherwise improperly determined the transfer prices within the organisation. […]

118. In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient)".

Albion Water's arguments

343. Albion Water quoted the following paragraph of the CAT's judgment in *Freeserve.com plc v the Director General of Telecommunications*[103] which cited the OFT's Guideline on the Application of CA98 in the Telecommunications Sector (OFT 417, March 2000):

"In considering whether an undertaking is engaging in price squeezing in breach of [CA98]*, the Director General will consider whether the dominant undertaking would be profitable in the relevant downstream market if it had to pay the same input prices as its competitors. A dominant undertaking may try to conceal a price squeeze by allocating*

to its upstream activities costs that are actually incurred as a result of its downstream activities".

344. Albion Water argued that, *"you are aware that Dŵr Cymru has* [....] *allocated downstream costs (e.g. customer facing costs) to its upstream activities […]. We find it difficult to imagine a clearer example of margin squeeze […]"*.

Conclusions on price squeezing

345. Paragraph 118 of the Telecommunications Notice is based on the premise that an undertaking operating on an upstream market is charging a price to an operator on a separate downstream market, which may be an unfair price. We have therefore considered the nature of the water supply services supplied by Dŵr Cymru and Albion Water respectively, in circumstances where Albion Water claims to be entitled to be charged a price by Dŵr Cymru which is sufficiently low to allow Albion Water to earn a reasonable profit on its water supply activity.

346. Prior to Albion Water's Inset Appointment, Dŵr Cymru had been supplying the relevant water to Shotton direct through the Ashgrove System. When Albion Water was granted its Inset Appointment, it simply purchased the water from Dŵr Cymru at the boundary of Shotton's premises (under the Second Bulk Supply Agreement), and sold it straight on to Shotton (under the Shotton Supply Agreement). It is difficult to see how, in practice, the nature of the "retail" activities carried out by Dŵr Cymru changed. It simply ceased supplying one customer (Shotton) and replaced this customer with a second customer (Albion Water).

347. Further, as discussed above, on 12 December 1996 we provisionally decided a price (26 p/m^3) as indicative of the price we would determine formally if we were asked to determine the Second Bulk Supply Agreement (although ultimately the parties agreed the same price without needing a formal determination). This price was based on other **retail** prices offered by Dŵr Cymru at the time (as well as Dŵr Cymru's estimated LRMC). The New Tariff, which is a retail tariff, is slightly below the price in the Second Bulk Supply Agreement. The price which Shotton agreed to pay Albion Water under the Shotton Bulk Supply Agreement is the same as that in the Second Bulk Supply Agreement. These are all consistent with Albion Water simply replacing Shotton as Dŵr Cymru's retail customer.

348. Importantly, we have seen no evidence that the arrival of Albion Water has resulted in Dŵr Cymru's ceasing to incur any retail costs. We asked Albion Water for details of the services it offers Shotton to assess whether Albion Water was carrying out any retail activities in the place of Dŵr Cymru. In a letter to us (undated, but received on 21 August 2002) Albion Water stated that,

"In summary, the services which [Shotton] *require from Albion Water are:*

- *the delivery of management information through analysis and monitoring of water use performance indicators*
- *a contribution to delivering against increasingly demanding company environmental objectives*
- *advice and provision of water management services*
- *interface between* [Dŵr Cymru] *and* [Shotton] *to deliver short term operational benefits [….]*
- *investigation of alternative resources and the provision of a secure and enhanced supply (e.g. our offer to* [Dŵr Cymru] *to take over and upgrade the existing infrastructure assets and to provide on-site treatment facilities to provide 'fit for purpose' water […])*
- *advice on ETP operations and safe recycling opportunities"*

349. It is difficult to see how any of the services currently provided by Albion Water replace retail supply activities that were previously offered by Dŵr Cymru direct to Shotton. Services such as *"the delivery of management information*", *"advice and provision of water management services", "advice on ETP operations and safe recycling opportunities"*, and *"interface between Dŵr Cymru and Shotton to deliver short term operational benefits"* all appear to be separate and distinct "value added" services, which can be offered by consultants for example. They are not part of the "retail" activity of water supply. Similarly, the "*Investigation of alternative resources*" is not a retail activity (and is not relevant for an undertaker which is already supplying water from an established water source, in this case from the Heronbridge Abstraction Point). The offer that was apparently made by Albion Water to Dŵr Cymru to *"take over and upgrade the existing infrastructure assets"* was, as we understand it, not accepted.

350. Importantly, the reference to the "*interface between* [Dŵr Cymru] *and* [Shotton] *to deliver short term operational benefits"* indicates that Dŵr Cymru was still carrying out a customer relations function for the benefit of Shotton. In the above undated letter Albion Water explained that, "*We have regular meetings with the* [Dŵr Cymru] *Customer relations' manager to act as a communication link between* [Dŵr Cymru] *and* [Shotton]. *This means we are able to resolve any potential problems and facilitate optimum use of water supply*".

351. We do not have any evidence that Dŵr Cymru ceased to incur any retail costs as a result of supplying Albion Water under the Second Bulk Supply Agreement, or that Dŵr Cymru would make any similar saving under Albion Water's proposed new arrangement. In simple terms, Dŵr Cymru will continue to supply the same water, through the same pipes, to the same premises. It will continue to issue one set of bills to one customer. Assuming that the relevant "upstream" and "downstream" operations are treatment/transport operations and retail operations respectively, it is not necessary to analyse the split, and

relationship, between these operations carried out by Dŵr Cymru, as Dŵr Cymru will continue to provide both.

352. In summary, we do not believe that Dŵr Cymru has abused a dominant position in breach of the Chapter II Prohibition in these circumstances, by engaging in price squeezing. In supplying Albion Water, Dŵr Cymru is in practical terms carrying on precisely the same water supply service and incurring the same costs as it was doing when it supplied Shotton directly,

Discrimination

Legal Test

353. Section 18(2)(c) CA98 (which reflects Article 82(2)(c) of the Treaty) provides that conduct may, in particular, constitute an abuse if it consists in:

"applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage."

354. The OFT's CA98 Guideline, "Assessment of Individual Agreements and Conduct" (OFT 414, September 1999) states:

"3.1 Price discrimination, and discrimination more generally, may be an abuse under the Chapter II prohibition. Whether it is an abuse depends on the effect of any discrimination on the market. […]

3.3 An undertaking can be said to be discriminating when it applies dissimilar conditions to equivalent transactions with other trading parties. The most direct way is through the prices charged to different sets of customers. It can take two basic forms:

- *an undertaking might charge different prices to different customers, or categories of customers, for the same product* [which means either goods or services] – *where the differences in prices do not reflect any differences in relative cost, quantity, quality or any other characteristics of the products supplied;*

- *an undertaking might charge different customers, or categories of customers, the same price even though the costs of supplying the product are in fact very different. A policy of uniform delivered prices throughout the country, for example, could be discriminatory if differences in transport costs were significant […].*

*3.5 Where there are objective reasons for an undertaking charging different prices to different customers, such as obviously different transport costs – **price differentiation** as distinct from price discrimination – the pricing structure would not be considered discriminatory. The term **price discrimination** hereafter refers to situations where differences in prices cannot be justified by differences in costs."*

Albion Water's arguments

355. Albion Water raised the following arguments in relation to its allegation that Dŵr Cymru was engaging in discriminatory conduct in breach of CA98.

356. Faults in Dŵr Cymru's calculation of the First Access Price: Albion Water argued that Dŵr Cymru was guilty of discriminatory pricing, because of faults in its methodology and calculation of the First Access Price. For example, in Albion Water's letter dated 14 May 2002, Albion Water argued that what it saw as the different costs of distributing water through non-potable and potable mains made the use of potable costs for a non-potable delivery service discriminatory (as well as anti-competitive).

357. In relation to this specific point, as discussed above, we do not believe that Dŵr Cymru was unreasonable to assume that the cost of transporting non-potable water in bulk was the same as the cost of transporting potable water.

358. At a more general level, we have seen no evidence that Dŵr Cymru was not prepared, in principle, to use the same methodology to calculate access prices for any third party seeking access to its networks as it used in calculating the First Access Price (although we are not aware that Dŵr Cymru was asked for other access prices).

359. Consistency with MD 163: Albion Water said that Dŵr Cymru's approach to the First Access Price was inconsistent with an open letter from the Director to the Managing Directors of all water undertakers dated 30 June 2000 ("MD 163") in which we stated that an undertaker should charge entrants as it would charge itself.

360. The statement in MD 163 that an undertaker should charge entrants as it would charge itself summarises our thinking on discrimination as it applied to common carriage. In theory, this would mean charging a third party in the same way that the undertaker would charge itself if it had separate distribution and production (resources and treatment) businesses. Because undertakers do not have separate businesses in this way, in practice it meant that undertakers should not set access prices for charging their competitors that were inconsistent with their final retail tariffs, without objective justification.

361. Dŵr Cymru based both its tariffs (including the New Tariff) and the First Access Price on regional average charging. Also there are close similarities between the way in which the First Access Price and the New Tariff were calculated (both use the same seven Step approach). There is therefore no evidence of the type of discrimination as discussed in MD 163 in this context.

362. Basing the access price on an unrepresentative class of customer: Initially, Albion Water claimed that Dŵr Cymru was guilty of discriminatory behaviour through basing its calculation of the First Access Price on an unrepresentative class of customer.

363. Albion Water argued that Dŵr Cymru's calculation of the First Access Price was not based on the costs of Shotton or [**] (i.e. the relevant customers in Albion Water's view). It also argued that the average regional costs of supplying users within the class of customers actually served by the Ashgrove System (i.e. Shotton and [**]) were far lower than those serving large industrial potable tariff customers. This suggested that, in Albion Water's view, the First Access Price should be de-averaged, reflecting direct costs (or costs "averaged" in name only by being based on costs of only two customers) rather than genuinely averaged costs.

364. However, in its letter of 14 May 2002, Albion Water withdrew this particular part of its complaint, and accepted that the access price could be based on average regional costs (rather than the direct costs of supplying Shotton, or the costs of supplying Shotton and [**]). Its letter stated: *"[…] there are two elements of the original complaint on which we will not proceed further. These are the use of regional average costs […]".* In addition, in its letter of 12 August 2003, Albion Water stated: *"you are very well aware that […] we accepted the use of regional average charges rather than local costs…"*. We have not therefore sought to address this issue in this decision.

365. Supply by Hyder Industrial: In its 5 July 2001 letter, Albion Water argued that "*The* [First Access Price] *proposed by Dŵr Cymru may potentially apply dissimilar conditions to equivalent transactions with other trading parties. It is significantly higher than prices offered during April and May 1997 by Dŵr Cymru's then sister company*, [Hyder Industrial]*, for a similar supply to a proposed new customer in the vicinity."* This was reiterated in Albion Water's solicitors' letter of 21 December 2001. Albion Water made express references in this context to section 18(2)(c) CA98 in, for example, its letters dated 8 March 2001 and 11 December 2000.

366. It appears that Albion Water was referring to papers that it provided to us at the time of its application for an Inset Appointment. At that time, in the context of its application for a bulk supply determination (which was ultimately not required, as the parties agreed the Second Bulk Supply Agreement), Albion Water sent us a series of correspondence between Hyder Industrial and Helm Consulting. Helm Consulting, acting for an undisclosed client, had requested a price for a supply of approximately 6,900Ml per year of non-potable water from the Milwr Tunnel source for potential supply to a site on the Deeside Industrial Park.

367. The correspondence supplied by Albion Water does indeed contain details of offers made by Hyder Industrial for the supply of non-potable water. However, the first of these offers dated 18 April 1997 for between 17.5 p/m^3 and 22 p/m^3 related to the cost of both the water resource and transport along an 11km pipe but did not include any treatment or filtering of the water. The second offer dated 12 May 1997 for 15 p/m^3 also related to the cost of the water resource and transport but did not include treatment or filtering. But this second offer assumed that the undisclosed client would be responsible for all capital costs involved in constructing the necessary infrastructure to transport the water.

368. In contrast, the First Access Price relates to the cost of transport and partial treatment. It does not include the cost of the water resource, nor allow for any capital contribution by Albion Water. The prices that Hyder Industrial offered to Helm Consulting's client are therefore based on quite different factors to those which underpin Albion Water's request for an access price from Dŵr Cymru.

369. Consequently, we conclude that Dŵr Cymru has not breached section 18(2)(c) CA98 in this respect.

Conclusions on discrimination

370. In light of the above, we conclude that Dŵr Cymru did not breach section 18(2)(c) CA98.

Conclusions on pricing aspects of Albion Water's complaint

371. In summary, we conclude that Dŵr Cymru did not abuse a dominant position in breach of the Chapter II Prohibition in respect of any of the price related aspects of Albion Water's complaint considered in this decision.

Non-price related alleged breaches of the Chapter II Prohibition

372. In addition to the specific complaints Albion Water made about the First Access Price, it also alleged that Dŵr Cymru had breached the Chapter II Prohibition for a variety of other reasons, which were not specifically related to the level, or calculation, of the First Access Price. These are considered below.

Delay

373. Albion Water has consistently argued that Dŵr Cymru has delayed the agreement of a satisfactory price relating to access to the Ashgrove System. In its letter of 10 November 2000, Albion Water complained that there would be a delay of almost three months before Dŵr Cymru

gave it any access price information. Albion Water considered this to represent anti-competitive behaviour.

374. In letters from Albion Water's solicitors dated 5 July 2001 and 21 December 2001 and a letter from Albion Water itself dated 12 August 2003, Albion Water repeated its complaints about Dŵr Cymru's failure to negotiate the access price or to provide information relating to the costs of the Ashgrove System. It appears that the issue of delay underpinned both of these aspects of the complaint. In its solicitors' letter of 21 December 2001, Albion Water specifically complained about Dŵr Cymru's *"extreme delay in putting forward a fully transparent and fair access price"* which it considered to be a breach of the Chapter II Prohibition.

375. Further, in a letter from Albion Water's solicitors dated 14 May 2002, Albion Water specifically indicated that it wished to pursue its complaint about the *"inordinate delay in achieving a satisfactory offer"*. Given that, at this stage, Dŵr Cymru had already provided the First Access Price and details of its methodology, it appears that Albion Water took issue not only with the length of time it took for Dŵr Cymru to provide it with access price information but also with the length of time it was taking to agree an access price which Albion Water considered to be satisfactory.

376. We had concerns about the time it took Dŵr Cymru to provide Albion Water with an access price. Following a letter from Albion Water to us dated 27 November 2000, we wrote to Dŵr Cymru on 28 November 2000 asking whether it had calculated an access price. We wrote again to Dŵr Cymru on 11 December 2000. Albion Water was provided with the Indicative First Access Price on 16 January 2001, and the First Access Price, including Dŵr Cymru's methodology, on 2 March 2001.

377. In principle, delay by an undertaker in providing an access price might constitute an abuse under the Chapter II Prohibition. However, there is no specific timescale within which an access price must be provided, even when an undertaker is under an obligation to do so. What is a reasonable timescale must be assessed on a case by case basis and will depend on the specific circumstances of each particular case. Consequently, even where there has been some delay in providing a price, this does not necessarily mean that this delay will constitute an abuse within CA98.

378. Although we had concerns about the time it took Dŵr Cymru to provide Albion Water with the First Access Price, we do not consider that this delay was sufficient to amount to an abuse within the Chapter II Prohibition in this instance for the following reasons. We note that Albion Water's access request was the first such request received by Dŵr Cymru. In the absence of a clear legal framework for calculating access prices (which the "Costs Principle" in WA03 will provide), we

accept that Dŵr Cymru needed some time to consider its approach to access pricing in the context of a particular request. In fact, in paragraph 161 of its Notice of Appeal, Albion Water observed*, "Dwr Cymru's* [sic] *4 month delay is relatively modest"*. There is no evidence that Dŵr Cymru deliberately delayed producing an access price for anti-competitive reasons. Given that we do not consider that the First Access Price offered by Dŵr Cymru represented an abuse of a dominant position, then what Albion Water perceived as a further delay in providing an access price satisfactory to Albion Water cannot amount to abusive conduct. Given the particular circumstances of this case, we have concluded that Dŵr Cymru's delay in producing an access price did not amount to the abuse of a dominant position.

Failure to provide information

379. In its letter dated 11 December 2000, one of the issues Albion Water complained about was Dŵr Cymru's *"refusal to divulge any information regarding the costs of the system and/or the apportionment of any costs."* This was repeated throughout the investigation and confirmed in Albion Water's solicitors' letter of 5 July 2001 and again in Albion Water's letter dated 12 August 2003.

380. We wrote to Dŵr Cymru on 29 January and 15 February 2001 requesting that it provide Albion Water with cost information to support the Indicative First Access Price. On 1 March 2001 ,we made the same request in relation to the First Access Price. Albion Water received this information on 2 March 2001, along with the First Access Price.

381. Dŵr Cymru did provide a significant amount of information about how it had calculated the First Access Price. This was enclosed in Dŵr Cymru's letter to us of 1 March 2001 and was subsequently copied to Albion Water in the letter of 2 March 2001. It did not provide information about the specific costs of running the Ashgrove System because the First Access Price had been calculated on the basis of average charges (something which Albion Water accepted). In the light of our conclusions on the First Access Price itself, we do not believe that Dŵr Cymru has abused a dominant position through any perceived failure to provide Albion Water with costs information.

Failure to negotiate

382. In its letter dated 11 December 2000, Albion Water also asked us to investigate under CA98 Dŵr Cymru's alleged *"persistent failure to negotiate the access price which Albion offered on 20 October* [2000] *[...]"*.

383. Although it appears from Albion Water's solicitors' letter dated 5 July 2001 that Albion Water now acknowledges that Dŵr Cymru was not under an obligation to reduce the First Access Price during negotiations

with Albion Water, or to accept Albion Water's approach in preference to its own, Albion Water's solicitors raised this issue again in subsequent correspondence.

384. In Albion Water's solicitors' letter dated 21 December 2001, it referred to *"Dŵr Cymru's persistent refusal [...] to put forward,* ***negotiate*** *or accept an access price which actually reflects the costs of providing the relevant service"* (emphasis added) as an aspect of Albion Water's complaint.

385. Dŵr Cymru was not under an obligation to reduce the First Access Price during negotiations with Albion Water or to accept Albion Water's approach in preference to its own. It was only under an obligation to provide access on terms which did not themselves amount to an abuse of a dominant position. Dŵr Cymru therefore did not breach the Chapter II Prohibition by failing to reduce the First Access Price during negotiations with Albion Water, or by failing to accept Albion Water's approach in preference to its own.

Changing tariffs in order to attribute additional costs to the access price

386. Albion Water argued on a number of occasions that Dŵr Cymru had begun the process of introducing a new standard non-potable tariff which Albion Water alleged would enable Dŵr Cymru to attribute additional costs to the access price. For example, in its letter dated 11 December 2000, Albion Water asked us to investigate a number of issues under CA98, including, *"claims by Dŵr Cymru that* [Albion Water's] *requests for parity of treatment had been pre-dated by discussions with Ofwat for a change in tariff structure that would impact on the non-potable supplies to the Ashgrove System"*.

387. In its letter dated 25 January 2001, Albion Water went on to say that, *"had Shotton Paper been a recipient of the Standard Published Tariff for non-potable water then all costs associated with the supply to this class would have been appropriate. That is demonstrably not the case, although we are alarmed that Dŵr Cymru might try to create a broader class retrospectively as a means for attributing extra costs to their access price and thereby denying us a legitimate competitive advantage. It would not surprise you that we would consider any such moves to be a significant breach of competition law."*

388. Finally, in the letter from Albion Water's solicitors dated 5 July 2001, Albion Water repeated its allegation that Dŵr Cymru had made it clear to Albion Water that it was proposing to introduce a new non-potable tariff which would apply to the supply to Shotton. If that were incorrect, Albion Water argued that Dŵr Cymru was guilty of misrepresenting its position but, if true, Albion Water argued that, *"[...] there has been an attempt by Dŵr Cymru to introduce a tariff which would have the effect of preventing competition, which could also be viewed as a breach of [CA98]"*.

389. The issue of whether Dŵr Cymru misrepresented the fact that it had been in discussions with us in relation to a new non-potable tariff is dealt with in paragraphs 400 to 402 below.

390. As discussed in paragraph 198 above, Dŵr Cymru has recently introduced a new non-potable tariff, including the New Tariff. We considered and approved this under WIA91. We have not considered the new non-potable tariff itself (or the New Tariff) under CA98. There is no evidence that Dŵr Cymru deliberately introduced the New Tariff to affect the calculation of the First Access Price to the detriment of Albion Water, or that the New Tariff (which was introduced **after** Dŵr Cymru produced the First Access Price) affected the calculation of the First Access Price. We do not therefore believe that Dŵr Cymru abused a dominant position by, as Albion Water has alleged, seeking to affect the calculation of the First Access Price through the introduction of a new non-potable tariff.

Changing the Indicative First Access Price

391. Albion Water also complained about Dŵr Cymru changing the access price it had originally offered to Albion Water. In its letter dated 8 March 2001, Albion Water referred to the fact that, on 16 January 2001, it received the Indicative First Access Price of 20p/m^3 which Albion Water maintained was formally approved by Dŵr Cymru's Board. This was then superseded by the First Access Price of 23.2p/m^3. Albion Water alleged that, *"Dŵr Cymru were taking full advantage of delays that they have introduced into the process to manipulate the figures and to produced [sic] an artificially high access price"*.

392. In the letter from its solicitors dated 5 July 2001, Albion Water stated that both the Indicative First Access Price of 20p/m^3 and the subsequent First Access Price of 23.2p/m^3 were represented by Dŵr Cymru as having been approved by the Board. Albion Water stated that it believed that the increase in prices was *"further evidence of anti-competitive behaviour, in that the* [Indicative First Access Price] *was deliberately misleading"*.

393. Albion Water's solicitors' letter dated 21 December 2001 referred to *"possible misrepresentation by Dŵr Cymru, during discussions with our clients about an access price, that the access price offered on 16 January 2001 had been approved by the Dŵr Cymru Board and/or a deliberate decision by the Board to subsequently raise the* [Indicative First Access Price] *by 18% for anti-competitive reasons"*.

394. Minutes of a meeting between Albion Water and Dŵr Cymru on 16 January 2001, which Albion Water provided to us, showed that the first price Dŵr Cymru provided was an **indicative** access charge of **around** 20p/m^3. An indicative price is not a final price and is therefore subject

to change. In light of this, we do not believe that it was unreasonable for Dŵr Cymru to seek to amend the first price.

395. Albion Water's complaint also raises the issue of whether Dŵr Cymru misrepresented the fact that the Indicative First Access Price of 20p/m^3 had received Board approval. However, Albion Water has not explained how any *"possible misrepresentation"* could, in itself, amount to the abuse of a dominant position. We have therefore concluded that Dŵr Cymru has not breached the Chapter II Prohibition in this respect.

396. Albion Water also alleges that the First Access Price was deliberately increased by Dŵr Cymru for anti-competitive reasons. However, despite the large amount of internal Dŵr Cymru papers we have reviewed during this investigation, there is no evidence to demonstrate that the Dŵr Cymru Board deliberately increased it for anti-competitive reasons as Albion Water alleges.

Misrepresentation

397. Albion Water complained about various alleged incidents of misrepresentation throughout the investigation.

398. In the letter from its solicitors dated 5 July 2001, Albion Water referred to what it perceived as a misrepresentation by Dŵr Cymru of its costs in connection with negotiating the access charge. Albion Water considered that such a misrepresentation, if it had taken place, would constitute an abuse within the meaning of the Chapter II Prohibition. This was reiterated in Albion Water's solicitors' letter of 21 December 2001.

399. Our views on the specific complaints made by Albion Water in relation to the First Access Price and Dŵr Cymru's methodology and calculation, are set out in paragraphs 250 to 307 above and include a finding that we have seen no evidence of deliberate misrepresentation or misallocation of costs by Dŵr Cymru. Moreover, Albion Water did not explain how any of the alleged misrepresentations could amount to an abuse of a dominant position, if the First Access Price to which they related did not itself amount to conduct which constituted the abuse of a dominant position.

400. In the 5 July 2001 letter Albion Water repeated its allegation that Dŵr Cymru had told Albion Water that it was proposing to take all non-potable supplies out of special agreements and put them on a new non-potable tariff and that it had been in discussions with us relating to this. Albion Water was concerned that Dŵr Cymru had misrepresented this to Albion Water and, if this was the case, maintained that this would amount to a breach of CA98. Albion Water repeated this allegation in its solicitors' letter of 21 December 2001.

401. The current non-potable tariff structure was effective from April 2003. The first correspondence relating to this was a letter from Dŵr Cymru to us dated 3 October 2002 which stated that *"we are intending to introduce new tariffs for non-potable water for 2003/04. We have yet to conclude the exact structure […]"*.

402. However, Dŵr Cymru had indicated to us in a letter dated 2 December 1998 that *"the current standard non-potable price is under review"*. The scope of the review to be carried out by Dŵr Cymru at that time was, however, unclear. It is possible that the review referred to in this letter encompassed the proposed changes that Dŵr Cymru discussed with Albion Water. It is not therefore clear whether Dŵr Cymru did misrepresent any facts. We have not attempted to resolve this question, as Albion Water has not explained how the alleged misrepresentation, if there were one, could amount to an abuse of a dominant position in itself (given our views on the introduction of the new non-potable tariff set out above).

Intentional abuse

403. As mentioned above, in its letter dated 14 April 2003, Albion Water referred to what it alleged were inconsistencies between Dŵr Cymru's initial arguments on treatment costs and its scheme of charges for 2003/04. Finally, in the Annex to Albion Water's letter dated 12 August 2003, Albion Water concludes by stating that, *"[...] we believe that Ofwat's evidence provides further proof that Dŵr Cymru has knowingly and willingly abused its dominance since* [CA98] *took effect."*

404. Our views on the detailed comments Albion Water made in relation to Dŵr Cymru's calculation of the First Access Price are set out above and include a finding that there is no evidence that Dŵr Cymru deliberately over-estimated the non-potable treatment costs as Albion Water alleges.

Inefficiency

405. In the letter from Albion Water's solicitors dated 5 July 2001, Albion Water indicated that it considered that the effect of Dŵr Cymru's proposed access price was to maintain the status quo which Albion Water alleged involved poor performance of the existing system and inadequate maintenance. Albion Water claimed there was a real threat of system under performance that would severely damage the viability of Shotton's business.

406. Dŵr Cymru has contested Albion Water's view of Dŵr Cymru's alleged inefficiency. Although in some circumstances it is possible for inefficiency to form part of abusive conduct[104], we have not sought to investigate this alleged inefficiency because Albion Water has not explained how any such inefficiency could amount to abusive conduct in this particular case.

Limiting production, markets or technical developments to the detriment of consumers pursuant to Section 18(2)(b) CA98

407. There are references to section 18(2)(b) CA98 in letters from Albion Water dated 11 December 2000 and 8 March 2001. It is not, however, clear from this correspondence how Albion Water believed Dŵr Cymru was in breach of this sub-section of CA98. We have not sought to resolve this question, as Albion Water has not explained in what way Dŵr Cymru's conduct could amount to a breach of sub-section 18(2)(b) CA98 in this case.

Conclusions on non-pricing aspects of Albion Water's complaint

408. In summary, we conclude that Dŵr Cymru did not abuse a dominant position in breach of the Chapter II Prohibition in respect of any of the non-pricing related aspects of Albion Water's complaint considered in this decision.

ANNEX 1 - ASSESSMENT OF THE ECONOMIC VIABILITY OF DUPLICATION OF THE ASHGROVE SYSTEM

1. In assessing whether it would be economically viable to duplicate the Ashgrove System, we have estimated the capital cost of building a suitable treatment works on site at Shotton to treat the raw water to the standard currently carried out by the Ashgrove Treatment Works to be approximately £1.9 million, and the capital cost of building the new main to be approximately £4.6 million, a total of approximately £6.5 million.

2. These cost estimates were made by carrying out a study of the various factors that make up the capital costs of laying a new pipeline and treating the water. The costs are taken from our current capital works cost base which consists of standardised unit costs submitted by water and sewerage undertakers for the coming price review in 2004. All prices are at the 2003/2004 price base, namely the last 'full' year for which figures are available. The figures used are the unit costs published under Regulatory Director Letter 22/03 (RD 22/03) entitled "Capital works unit costs in the water industry: Feedback on Ofwat's analysis of the March 2003 water company cost base submissions (May 2003)". We use the standardised unit costs as a means of comparing the efficiency of procurement of capital projects between water companies.

Table 1 below sets out the estimated cost of the supply pipeline in detail.

Table 1 – Supply Pipeline Costs

Type of Land	Estimated Length of New Pipe (Km)	Costbase Likely Benchmark Unit Rate (£000)	Likely Cost (£000)
Grassland[1]	7	184	1288
Rural/sub highway[1]	5	269	1347
Urban highway[1]	2	323	646
Crossings[2]	1	2x617	1234
Compensation to landowners	N/A	N/A	75
Total	**15**		**4590**

[1] Price base is 02/03 inflated by RPI to 03/04.
[2] Rate not from cost base, but rather interpreted from the CESSM3 price database 1999/2000, (section on special pipe laying). The Civil Engineering Standard Method of Measurement (CESSM3) price database 1999/2000, edited by quantity surveyors E C Harris, is the fifth edition of what has come to be regarded as the standard in the provision of civil engineering information. Inflated by RPI to 03/04.

3. This table shows the total length of the proposed supply pipeline as 15 kilometres. This may be an over-estimate of the length of the pipeline needed to duplicate the Ashgrove Pipe. A note dated 4 March 1996 describing the Ashgrove System provided by Dŵr Cymru under cover of its response to a Section 26 Notice dated 29 June 2001 indicated the

Ashgrove Pipe to be approximately 12 kilometres long. Also a new pipeline might be able to take a more direct, and thus less expensive, route to Shotton and [**]. The estimated length of the pipeline is apportioned according to the type of land through which the main would run, based on our broad assessment of the local area using Ordnance Survey maps. Individual distances are multiplied by the benchmark unit rate for that type of land to give a total estimated cost of approximately £4.6 million.

4. We estimated the nominal capacity of the main to be 24Ml per day. This would provide sufficient capacity to transport the required daily volume to Shotton (an average of 18.10 Ml up to a maximum of 22Ml per day by agreement).

5. If Albion Water were to use its pipe-laying powers under section 159 WIA91, compensation would be payable to the landowner under section 180 and Schedule 12 WIA91 for any depreciation in the value of the land caused by the pipe-laying. Such compensation depends on the value and extent of land affected by the pipe-laying. We estimate that, in this case, compensation could be in the region of £45,000 on the basis of a 7km strip of grassland. Allowance is also made for disturbance and other consequential losses. Such costs are quite unpredictable. However, we estimate that these could be in the region of £30,000. No compensation is payable in respect of pipes laid in streets. This gives a total estimate of £75,000 for compensation to landowners.

6. Table 2 below shows the estimated cost of a treatment works to treat the raw water to the standards currently delivered by the Ashgrove Treatment Works to be approximately £1.9 million assuming a daily supply rate of 18.1 Ml.

Table 2 – Treatment Costs[1]

Costbase Descriptor	**Costbase Likely Benchmark Unit Rate £000/Ml/day**
New Water Treatment Works Surface Water Type 2 (to drinking water standard, including filters)[2]	182
Replace Filters	-76
Works without Filters	106
Flow	x 18.1 Ml/day
Total	**1917**

[1] Price base is 02/03 inflated by RPI to 03/04.

[2] Surface Water Type 2 ("SW2") refers to the type of raw water (that is untreated water) quality from which potable water is produced. In order to estimate the cost of a treatment works producing the lower standard of water that would be produced by the Ashgrove Treatment Works the cost of the filters from a SW2 works was removed.

7. To assess the economic viability of duplicating the Ashgrove System, we used the above costs to calculate the Net Present Value ("NPV") of this option. The NPV is the value today of all cash inflows netted against all cash outflows of a project lasting a number of years, based on an assumed rate of return. The rate of return is the annual income and capital growth from an investment, expressed as a percentage of the original investment. A positive NPV means that the 'present value' of all cash inflows and residual asset values are greater than the 'present value' of cash outflows taking into account an appropriate rate of return.

8. We looked at four scenarios in the NPV calculations which differ depending on the type of new entrant[105], length of asset life, and rate of return. These scenarios are as follows:

   (a) a large water and sewerage undertaker ("WaSC") using a regulatory asset life[106] and a rate of return of 5.5%;

   (b) a small water only undertaker ("WoC") using a regulatory asset life and a rate of return of 6.5% ("Small WoC 1");

   (c) a small WoC using a 25-year asset life and a rate of return of 10% ("Small WoC 2"); and

   (d) a small WoC using a 10-year asset life and a rate of return of 20% ("Small WoC 3").

   The asset life and rate of return assumptions are explained below.

9. We considered these four scenarios in order to assess the economic viability of duplication for various undertakers which might be interested in duplicating the Ashgrove System. We looked at the three small WoC cases to cover a range of assumptions from those normally used in the water industry in England and Wales to those suggested by Albion Water in its correspondence with us.

10. 'Regulatory asset life' describes the regulatory convention within the water industry in England and Wales that (underground) infrastructure assets are assumed to have an infinite life. This convention is based on the assumption that the asset owner carries out adequate maintenance to ensure that there is no loss in these assets' long-term capability and hence their value. The convention for non-infrastructure assets (such as, in this case, the treatment works) is that they have an asset life of 35 years. For the NPV calculation, this requires the infrastructure assets (the pipe which will duplicate the Ashgrove Pipe) to be carried forward in a non-depreciated sum, and the non-infrastructure assets (the treatment works which will duplicate the Ashgrove Treatment Works) to be reduced by the likely current cost depreciation.

11. A '25-year asset life' assumes that all assets depreciate fully over 25 years. A '10-year asset life' assumes that all assets depreciate fully over 10 years. These assumptions are not standard for the water industry in England and Wales. We have included 25-year and 10-year asset life assumptions in the calculations to cover the unusual case of a small WoC which considers that its assets would have no value after 10 or 25 years. This case might apply where a small WoC had a contract of 10 or 25 years with one customer and did not expect to be able to serve that customer (or other customers) or to realise any value from the assets at the end of the contract period.

12. The pre-tax rates of return of 5.5%, 6.5%, 10% and 20% have been chosen for the following reasons. We currently allow existing WaSCs a regulatory rate of return of 5.5%. We allow a regulatory rate of return of 6.5% for small WoCs. Albion Water indicated in its letter of 12 August 2003 to us that Pennon would typically expect a 20% pre-tax rate of return (which equates to 14% post tax) where Pennon was providing investment funds. In addition to the 5.5%, 6.5% and 20% values, we also selected 10% as an intermediate point. These different assumptions illustrate the effect of a range of rates of return on the NPV calculation.

13. In order to assess the viability of duplication, assumptions have to be made concerning the period over which the undertaking seeks to recover its construction and operating costs. We have estimated above that planning, design and legal considerations would take approximately 9 months. However, since these preliminary activities would typically precede the majority of investment, it has been assumed that there is a 1-year time lag between the capital investment being made and the facility becoming fully operational.

14. For each of the four scenarios, we considered NPV periods of 25, 15 and 10 years to demonstrate the effects of adopting longer and shorter investment periods. We chose 10 years as the shortest period because Albion Water suggested to us that the NPV calculations should be based on the length of the Shotton Supply Agreement, which is a 10-year contract. A 10-year period is relatively short compared to those normally used in the water industry in England and Wales.

15 In the cases where the asset life is longer than the NPV period, the assets will have a residual value at the end of the period and this residual value is included in the NPV. In respect of the cases with a 'regulatory asset life', the residual values have been obtained by applying this regulatory convention to the assets associated with the duplicate scheme. The calculation of these residual values is shown in Table 3.

Table 3 – Residual values

Time horizon (years)	Non-infrastructure assets residual years	Yearly depreciation (£m)	Residual value of non-infrastructure assets (£m)	Residual value of infrastructure assets (£m)	Total residual value (£m)
10	26	0.053	1.3	4.5	5.8
15	21	0.053	1.1	4.5	5.5
20	16	0.053	0.8	4.5	5.3
25	11	0.053	0.5	4.5	5.0

Notes: Assets are assumed to be built in year 0 and start depreciating in year 1. Residual values are rounded to £0.1m.

16. We consider that these residual values are appropriate for a WaSC or WoC operating in a regulated environment. It is possible that these assumptions would not be applied by an organisation with a small customer base. This is recognised by the two cases with asset lives of 25 and 10 years.

17. In calculating the NPV, we have made the additional assumptions set out below.

(a) The retail price against which the company considering duplicating the Ashgrove Pipe and the Ashgrove Treatment Works would need to compete is 26.6p/m^3. This is equivalent to the New Tariff[107], which is slightly higher than the price currently paid by Shotton to Albion Water under the Shotton Supply Agreement.

(b) The volume supplied is 18.1 Ml per day, which is the average daily volume supplied to Shotton by Albion Water under the Shotton Supply Agreement (please see paragraph 66 in the main body of the decision) [108].

(c) The cost of buying the raw water is 3p/m^3 (circa £200,000 per year)[109].

(d) The operating cost of treating the water is 2p/m^3, and the operating cost of distributing it is 1p/m^3 (i.e. a total of approximately £200,000 per year)[110].

(e) [**] This is likely to be a high estimate as flow balancing may not be appropriate in this case. The costs for the flow balancing relate to the use of the lagoons at [**] which are described in paragraph 54 above. Indeed, Albion Water indicated in its letter of 25 February 2003 that the flow balancing system provided by [**] would not be necessary if there were mechanisms which adjusted delivery to the customer's demand.

(f) Incremental business costs are 4 p/m^3 (i.e. circa £270,000 per year). This is our estimate of the likely incremental business costs involved in the construction of a duplicate pipeline and water treatment works.

(g) The WaSC or relevant small WoC will have to purchase an additional 5% of water volume over and above the amount required by Shotton to allow for water losses through leakage and operational use.

(h) The WaSC or relevant small WoC will only be able to use the new pipe to supply Shotton, and not other customers (such as, for example, [**]). This appears to be a very cautious assumption because Dee Valley, Dŵr Cymru and United Utilities Water provided information showing that there are other potential customers which could use a duplicated pipe nearby. In addition, correspondence from Albion Water during its Inset Appointment application and subsequent correspondence shows that Albion Water considered supplying other large users in the area at this time. Further, Albion Water wrote to us on 30 October 2003, enclosing a letter from [**] to Albion Water dated 11 July 2003. The letter from Albion Water to us explained that there was interest from [**] in Albion Water as a potential water supplier and that the letter from [**] to Albion Water confirmed this demand. The letter from [**] asked Albion Water to confirm that it was able to bid for the supply of three of [**] larger sites in Wales, including the site next to Shotton, which uses an average of approximately [**] Ml per year.

18. The NPVs for the four cases, using the three NPV periods and the additional assumptions explained above, are set out in Table 4.

Table 4 - Net Present Values (£m)

	Asset life	Rate of Return	25-year NPV period	15-year NPV period	10-year NPV period
WaSC	Regulatory	5.5%	**7.8**	5.5	3.9
Small WoC 1	Regulatory	6.5%	**6.4**	4.6	**3.3**
Small WoC 2	25 years	10%	2.4	**1.5**	0.8
Small WoC 3	10 years	20%	-1.2	-1.5	**-2.0**

19. Of the 12 possible cases we looked primarily at four 'base cases' which we considered were the most plausible (highlighted in bold in Table 4). The base cases reflect the level of risk assumed by the different companies (the investment is less risky for a WaSC than for a small WoC). The four base cases are as follows:

    (a) WaSC: regulatory asset life, 5.5% rate of return and 25-year NPV period;
    (b) Small WoC 1: regulatory asset life, 6.5% rate of return and 25-year NPV period;
    (c) Small WoC 2: 25-year asset life, 10% rate of return and 15-year NPV period; and
    (d) Small WoC 3 case: 10-year asset life, 20% rate of return and 10-year NPV period.

20. In choosing the base cases we assumed that there is a link between the level of risk on the one hand, and the NPV period, the asset lives and the rate of return, on the other. The NPV assumptions are particularly harsh for Small WoC 2 and Small WoC 3 base cases compared to the other base cases. For example in the case of Small WoC 3 we assumed a very short asset life, a very high rate of return and a very short NPV period. All of these assumptions act to reduce the overall NPV.

21. Considering the base cases in turn, Table 4 shows that the NPV for the WaSC base case is £7.8 million. The NPV for Small WoC 1 base case is £6.4 million. The NPV of Small WoC 2 is £1.5 million. Finally, the NPV of Small WoC 3 is -£2.0 million. Therefore, of the four base cases, only Small WoC 3 shows the duplication of the Ashgrove System not to be profitable.

22. We have also conducted a sensitivity analysis by allowing for variations in the assumptions underlying the four base case scenarios. The sensitivities we have selected are described below.

23. **Case "C+" - Capital costs increased by 25%:** As our cost estimates are based on a desk-top exercise, we calculated a case based on capital costs being 25% higher. Cost base submissions strip out

certain job-specific elements such as river crossings (although we have expressly included additional capital costs to cover a double river crossing in all cases). A 25% increase is a typical engineering margin of error to consider when examining desk-based estimates (see "Chemical Engineering Guide to Capital Cost Estimating").

24. **Case "V-" - Annual Water Volume of 5.24 million m^3 per annum (22% reduction):** We carried out this sensitivity analysis because Albion Water indicated in its letter of 12 August 2003 that Shotton's water consumption would decrease in the future and that the NPV should be based on the above figure. However, we are not certain that such a reduction is appropriate. First, Albion Water has in the past indicated that Shotton's water consumption would increase. Second, in its letter of 12 August, Albion Water gave projected reduced figures for only one year. Third, Albion Water provided us with a business plan to 2007 on 28 November 2003. The projected volumes that could be inferred from this business plan demonstrated that there would not be a drop in volume below 6,600Ml per year during this period. Finally, even if Shotton's consumption were to decrease, there is also the possibility that Albion Water could supply [**]. [**] can demand up to [**] per day from Dŵr Cymru. As discussed above, Albion Water has informed us that [**] has shown an interest in being supplied by Albion Water. Over the past few years in practice [**] has used the following daily averages: 1998 to 1999 – [**]Ml; 1999 to 2000 – [**]Ml; 2000 to 2001 – [**]Ml; and 2001 to 2002 – [**]Ml.

25. **Case "O-" - Ongoing costs reduced by 20%:** This is indicative only to show the effects on the NPV of lower ongoing costs.

26. **Case "O+" - Ongoing costs increased by 20%:** Again, this is indicative only to show the relevant effects on the NPV.

27. **Case "C+O+V-" - A combination of C+, O+ and V- above:** This case includes capital costs increased by 25%, ongoing costs increased by 20% and an annual water volume reduced to 5.24 million m^3 per year. It should be considered a "worst case scenario".

28. **Case "IC" - Including [**] water volumes:** This case includes an additional volume of [**]Ml per year from [**]. This is the average annual volume over the period 1998-2002 and equates to approximately [**] Ml per day.

29. **Case "O- IC" - A combination of O- and IC above:** This case includes a reduction in operating costs of 20% and an additional volume of [**] Ml per year from [**]. It should be considered as a "best case scenario".

Table 5 - Sensitivity Analysis of the Net Present Value (in £m) for the four 'base cases'

Base Case	C+O+V- ("worst case scenario")	C+	V-	O+	Base	O-	IC	O-IC ("best case scenario")
WaSC	2.5	6.6	5.2	6.0	**7.8**	9.7	11.3	13.8
Small WoC 1	1.4	5.1	4.0	4.7	**6.4**	8.1	9.5	11.7
Small WoC 2	-2.0	0.2	0.1	0.5	**1.5**	2.5	3.2	4.6
Small WoC 3	-4.4	-3.3	-2.7	-2.5	**-2.0**	-1.5	-1.3	-0.6

Note:
WaSC base case = regulatory asset life, 5.5% rate of return and 25-year NPV period.
Small WoC 1 base case = regulatory asset life, 6.5% rate of return and 25-year NPV period.
Small WoC 2 base case = 25-year asset life, 10% rate of return and 15-year NPV period.
Small WoC 3 base case = 10-year asset life, 20% rate of return and 10-year NPV period.

30. Table 5 shows the effects of the sensitivity analysis on the four base cases (please see figures highlighted in bold in Table 5 above). For the WaSC, seeking a 5.5% rate of return, the base case NPV is £7.8 million. With an increase of 25% in capital costs, the NPV remains high at £6.6 million. The NPV remains positive for the WaSC for each of the sensitivities shown including the worst case scenario where the NPV is £2.5 million.

31. For Small WoC 1, seeking a 6.5% rate of return, the base case NPV is £6.4 million. The NPV for this type of small WoC remains positive for all of the sensitivities that we evaluated. In the worst case scenario the NPV remains positive at £1.4 million. The first two rows of the table therefore show that the provision of a duplicate pipeline by a regulated undertaker, whether a WaSC or a small WoC, seeking a typical regulated rate of return of 5.5% to 6.5% is profitable in the range of cases we examined.

32. For small WoC 2, requiring a 10% rate of return, the base case NPV is £1.5 million. For this type of small WoC, the worst case "C+O+V-" sensitivity produces a NPV of minus £2.0 million. The "C+O+V-" sensitivity assumes that there are three simultaneous (negative) events and, in practice, it is unlikely that this would occur. All other sensitivities for small WoC 2 result in positive NPVs.

33. Finally, for small WoC 3, requiring a 20% rate of return, the base case NPV is minus £2.0 million. For this type of small WoC the NPV is negative for all of the sensitivities evaluated which require a 20% rate of return. This indicates that the provision of a duplicate pipeline is unlikely to be a viable option for organisations of this type seeking a

very high rate of return over 10 years unless some residual value beyond this period can be realised.

34. Finally, to complete the analysis we also calculated the "break-even" rate of return. In the cases under consideration when the desired rate of return increases the NPV tends to decrease. The rate of return that produces a zero NPV is described as the "break-even" rate of return. We calculated the "break-even" rate of return for the base cases and each of the sensitivities outlined above. These are shown in Table 6 below. They are the highest rates of return that will still allow the project to break even. If the rates of return were higher, the projects would have negative NPVs. If they were lower, the projects would have positive NPVs.

Table 6 – Break-even rates of return (in annual percentage rates)

Base Case	C+O+V- ("worst case scenario")	C+	V-	O+	Base	O-	IC	O-IC ("best case scenario")
WaSC	8.1	12.3	12.2	13.2	**15.5**	17.8	19.2	22.0
Small WoC 1	7.9	12.1	12.0	13.0	**15.4**	17.7	19.0	21.9
Small WoC 2	5.4	10.3	10.2	11.3	**13.9**	16.5	18.0	21.1
Small WoC 3	N/A	4.3	4.2	5.7	**9.1**	12.3	14.1	17.8

Note:
WaSC base case = regulatory asset life, 5.5% rate of return and 25-year NPV period.
Small WoC 1 base case = regulatory asset life, 6.5% rate of return and 25-year NPV period.
Small WoC 2 case = 25-year asset life, 10% rate of return and 15-year NPV period.
Small WoC 3 case = 10-year asset life, 20% rate of return and 10-year NPV period.
Please see following paragraph for explanation of the underlined figures.

35. Table 6 shows that only one of the cases would never be economic (the unlikely "C+O+V-" sensitivity for small WoC 3). It also shows that in all but five cases (those underlined in Table 6) it would be economic to duplicate the Ashgrove System at higher rates of return than are currently required by water undertakers (i.e. above 6.5%). This means that for water undertakers operating at a 5.5% or 6.5% rate of return, the project becomes very profitable in all but five cases.

36. In summary, the NPV analysis we carried out shows that in the majority of the scenarios considered it would be economically viable to duplicate the Ashgrove System. It is only in relation to Small WoC 3 where the assumptions used were not only extremely unfavourable but also not those normally used in the water industry, that the base case NPV is negative. In all other base cases that we examined the NPV is positive demonstrating that it would be economically possible to construct duplicate infrastructure.

37. Even when we varied the assumptions underlying the analysis to look at the sensitivity of the NPV results, in the WaSC and Small WoC 1 scenarios the NPV values still remained positive. For Small WoC 2, six

of the seven sensitivity variations resulted in a positive NPV. Only for Small WoC 3 did the base case and the sensitivities all produce negative NPVs.

38. Finally, we calculated break-even rates of return for the duplication of the Ashgrove System. This analysis shows that duplication is likely to be economic, producing rates of return of 6.5% or more, in all but five of the sensitivities evaluated.

39. If any additional customers were to be supplied by the duplicate pipe, the NPV and the rate of return would both increase. This would serve to shorten the time taken to recoup the investment and consequently reduce the risk assumed by the WaSC or relevant small WoC. One such potential customer is [**] which, as mentioned above, Albion Water has indicated has shown an interest in being supplied by Albion Water (and one of the variations in our sensitivity analysis caters for this eventuality). But we have also seen evidence that there may be other potential customers in the area, which are not covered by our sensitivity analysis, and which might therefore further increase the NPV and rate of return. Assuming that only one or two customers would be available might therefore be a conservative assumption. Indeed, as discussed above, we have made other conservative assumptions in our analysis, which increases the likelihood that our conclusions would prove to be realistic in practice.

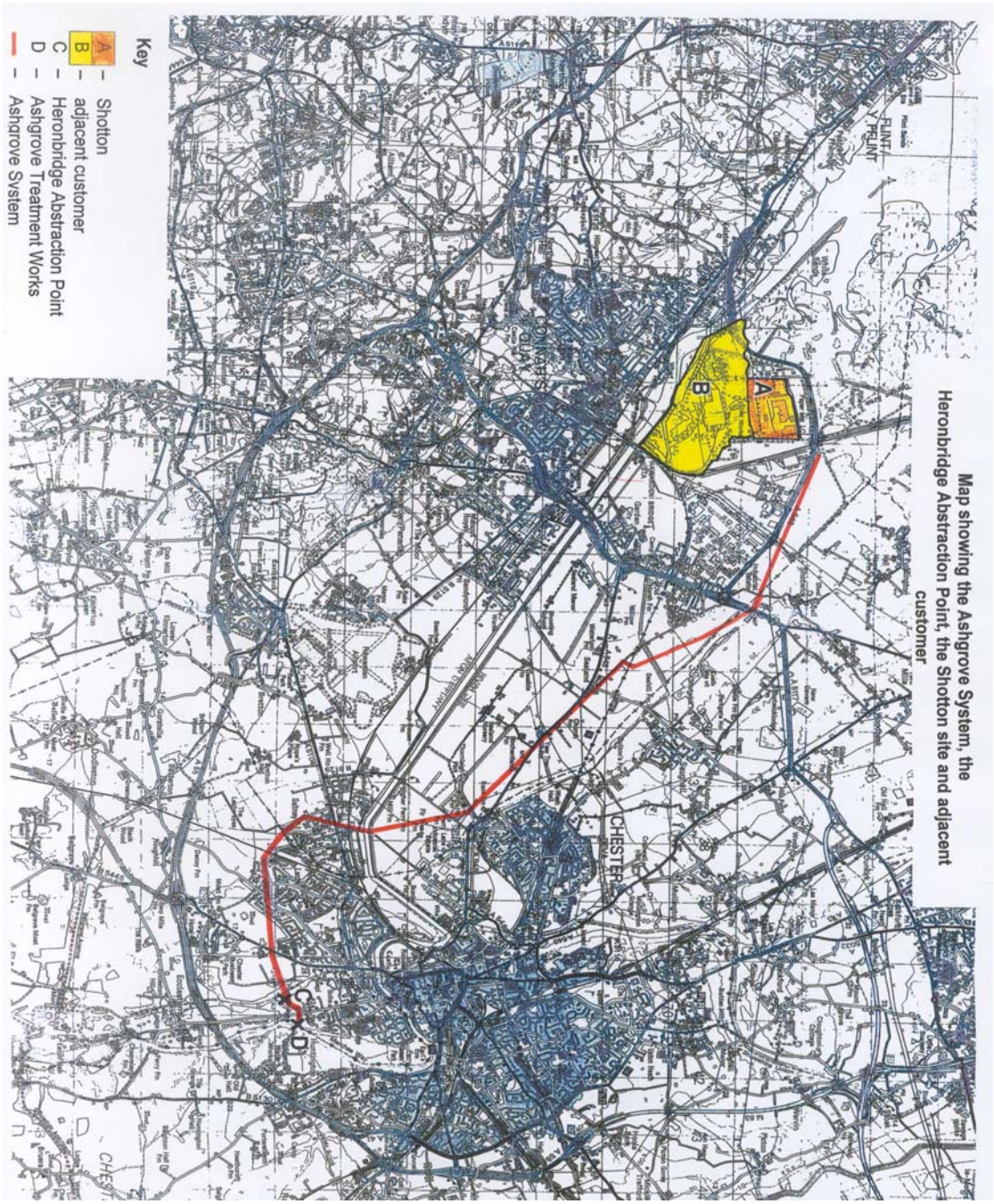
ANNEX 2

MAP OF ENGLAND AND WALES SHOWING THE WATER SUPPLY AREAS OF ALBION WATER, DEE VALLEY, DŴR CYMRU AND UNITED UTILITIES WATER

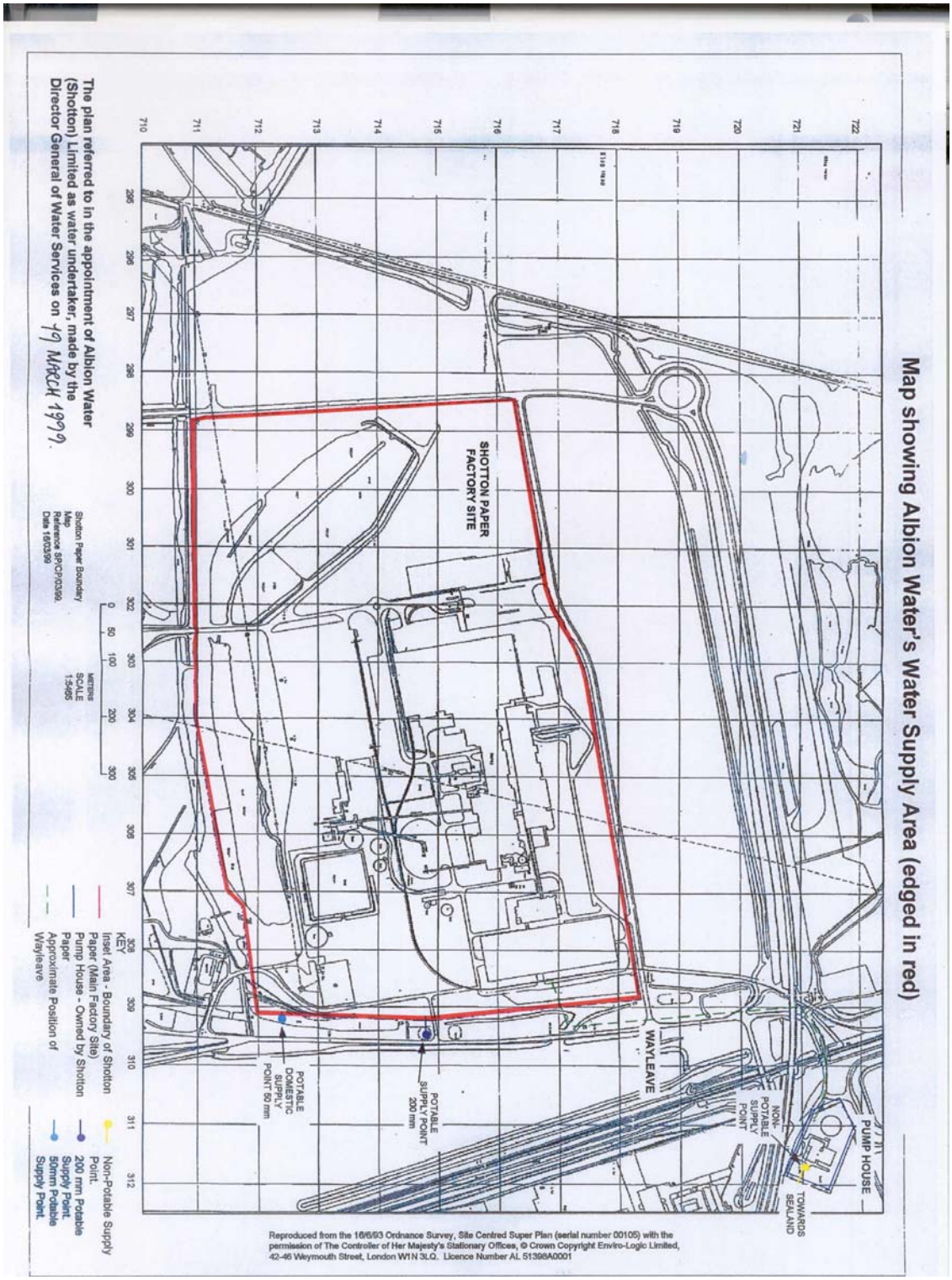
KEY:
DVW Dee Valley

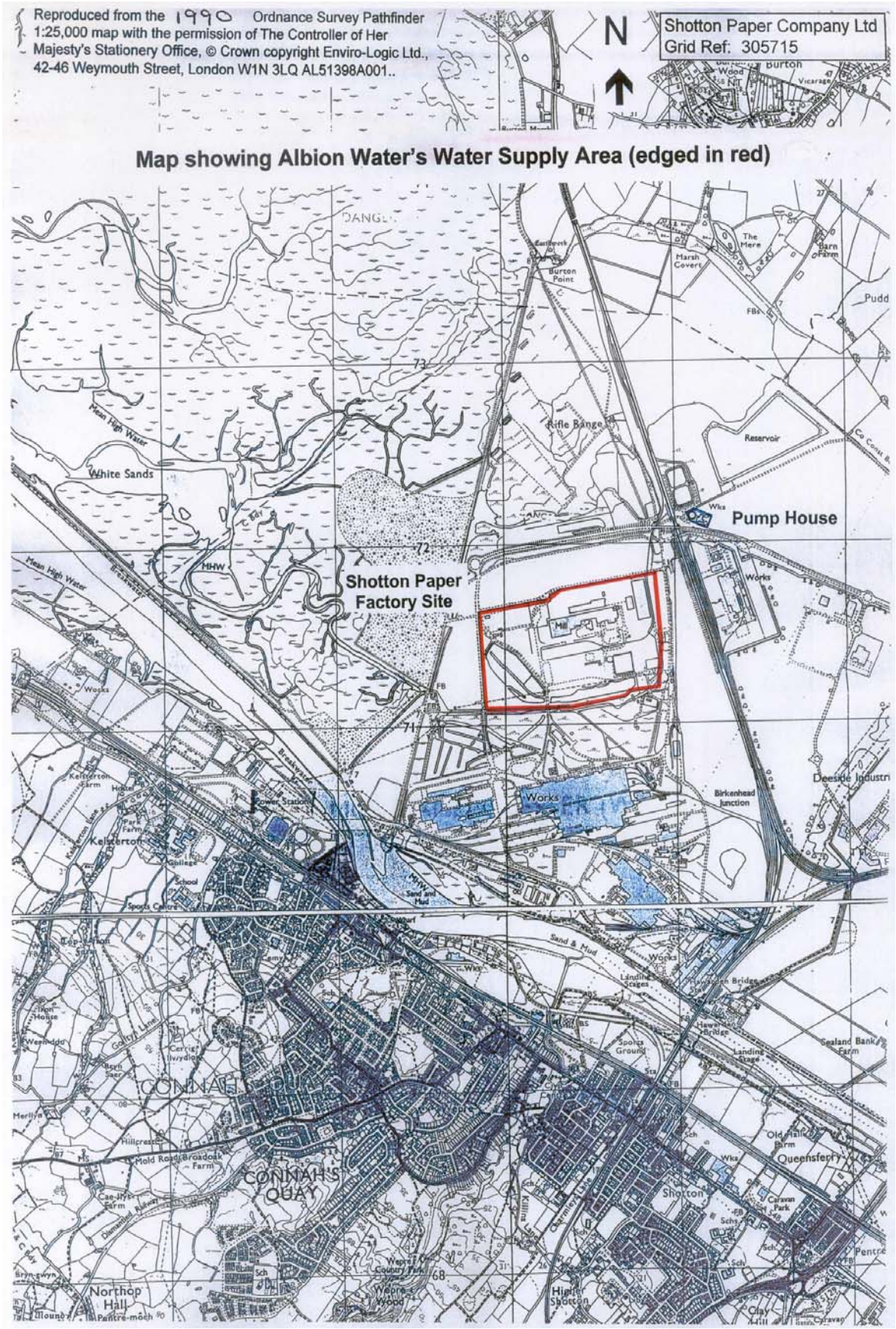
NOTES:
Albion Water's Water Supply Area is not to scale

ANNEX 3 - MAP SHOWING THE ASHGROVE SYSTEM, THE [adjacent customer] SITE, THE HERONBRIDGE ABSTRACTION POINT AND THE SHOTTON SITE**



ANNEX 4 - MAPS SHOWING ALBION WATER'S WATER SUPPLY AREA (EDGED IN RED)




Reproduced from the 1990 Ordnance Survey Pathfinder 1:25,000 map with the permission of The Controller of Her Majesty's Stationery Office, © Crown copyright Enviro-Logic Ltd., 42-46 Weymouth Street, London W1N 3LQ AL51398A001..
N
Shotton Paper Company Ltd
Grid Ref: 305715
Map showing Albion Water's Water Supply Area (edged in red)
Pump House
Shotton Paper Factory Site
Mean High Water
White Sands
Rifle Range
Reservoir
Works
Mill
Kelsterton
Connah's Quay
Shotton
Queensferry
Northop Hall
Deeside Industri
Birkenhead Junction

[1] The exceptions are that only the OFT may issue guidance on penalties and make and amend the OFT's procedural rules.

[2] Section 31(3) of the Water Industry Act 1991, as inserted by Schedule 10, paragraphs 5(5) and 5(6) CA98.

[3] Section 18(1) CA98 is subject to section 19 CA98 which provides that the Chapter II Prohibition does not apply to certain defined cases. Under section 18(3) CA98, 'dominant position' means a dominant position within the UK, or any part of it, and 'UK' means the UK or any part of it.

[4] Case 85/76 *Hoffman-La Roche & Co. AG v Commission,* [1979] 3 CMLR 211, paragraph 91.

[5] Competition Act 1998 (Commencement No. 5) Order 2000, SI 2000/344.

[6] Although the guidelines on the application of CA98 were produced by OFT, the regulators with concurrent powers under CA98, were involved in the drafting of the guidelines.

[7] The Treaty is defined as the Treaty establishing the European Community (Section 59(1) CA98).

[8] The European Court is defined as the Court of Justice of the European Communities and includes the Court of First Instance (section 59(1) CA98).

[9] Further details of section 60 CA98 can be found in section 6 of the OFT Guideline, "The Major Provisions" (OFT 400, March 1999).

[10] *Napp Pharmaceutical Holdings Limited and subsidiaries v The Director General of Fair Trading* 2002 [CAT] 1.

[11] Now the Competition Appeal Tribunal.

[12] *In re H [1996]* AC 563, discussed in paragraphs 96, 107 and 108 of *Napp.*

[13] The Director General of Fair Trading (who has now been replaced by the OFT).

[14] *Claymore Dairies Limited and Express Dairies plc v Director General of Fair Trading* [2003] CAT 3.

[15] The relevant functions of the Secretary of State for Wales were transferred to the National Assembly of Wales by the National Assembly of Wales (Transfer of Functions) Order 1999 (SI 672/99).

[16] As inserted by paragraph 5(4) of Schedule 10 CA98. Section 6B WIA91 (also inserted by paragraph 5(4) of Schedule 10 CA98) provides however that when exercising any CA98 function the Director may have regard to any matter in respect of which a Section 2 WIA91 Duty is imposed, to which the OFT could also have regard when exercising that CA98 function.

[17] Under section 7(4)(c) the Director can also replace an incumbent undertaker with another company pursuant to a relevant Licence Condition in the incumbent undertaker's Licence, but this possibility is not normally referred to as a possible "inset appointment". Under Licence Condition O the Secretary of State can give notice, which must be at least 25 years for all undertakers except Albion Water, to terminate an undertaker's Licence.

[18] 1 megalitre equals 1,000m^3, and therefore 100 megalitres equals 100,000 m^3.

[19] Undertakers do not have the exclusive right to supply water within their Water Supply Areas, because it is always possible for private suppliers to supply water. The main differences between undertakers and private suppliers are that previously publicly owned infrastructure, including pipes and treatment works, was vested in undertakers at privatisation, and only undertakers have for example statutory pipe-laying powers under WIA91. Undertakers only have a form of "exclusivity" in the sense that at any one time there can only ever be one undertaker (either an "incumbent" undertaker, or an

Inset Appointee which has replaced the incumbent undertaker) for any particular area within England and Wales.

[20] Please see sections 40 and 40A WIA91 and the definition of "supply of water in bulk" in section 219(1) WIA91.

[21] Section 40 WIA91 provides for determination by the Director of a new bulk supply agreement. Section 40A WIA91 provides for variation or termination of an existing bulk supply agreement.

[22] "Extending Opportunities for Competition in the Water Industry in England and Wales", July 2002 (see paragraphs 187 to 191 in particular), and "Competition in the Water Industry in England and Wales", April 2000 (see paragraphs 9.2 to 9.10).

[23] Inserted by section 3 of Schedule 4 WA03.

[24] On this basis, Albion Water's proposal to supply Shotton (with water purchased by Albion Water from United Utilities Water) through Dŵr Cymru's pipes would be prohibited by new section 66I(1) WIA91. However, section 66I(3) WIA91 and 66I(8) WIA91 will give the Secretary of State, or the National Assembly for Wales (in relation to systems of undertakers wholly or mainly in Wales), the power to specify additional circumstances where the prohibition shall not apply. Further, under section 66K WIA91, the Secretary of State or the National Assembly for Wales (in relation to systems of undertakers wholly or mainly in Wales) will be able to grant exemptions to the prohibition in section 66I(1) WIA91. Policy on exceptions and exemptions is currently being developed by Ofwat, DEFRA and industry stakeholders. Alternatively, Albion Water may still be able to implement its proposal if Albion Water successfully applies for a Combined Licence under WIA91 as amended by WA03 (see the following endnote).

[25] Albion Water could not therefore obtain a Combined Licence unless it ceased to be an undertaker.

[26] Section 39(4) WA03 which will amend section 2 WIA91, and in particular insert new section 2(3)(d)(iii) WIA91.

[27] Please see the notes to Condition 7 on page 29 of a consultation paper issued by DEFRA and the National Assembly for Wales in February 2004 entitled "Water Supply Licensing – Modifications to Water Undertakers' Existing Conditions of Appointment; Standard Conditions of Water Supply Licences".

[28] Schedule 3, paragraph 5(2) CA98.

[29] [**]

[30] See paragraphs 34 to 49 below for further details on this temporary arrangement.

[31] A Section 26 Notice is a written notice issued by the Director under section 26 CA98 requiring the recipient to produce specified documents or information to the Director. The Director may issue a Section 26 Notice if he has reasonable grounds for suspecting that there has been an infringement of CA98.

[32] See paragraph 52 for a definition of "non-potable water".

[33] A company holding a Licence under WIA91 may both carry out its functions as an undertaker ("regulated business") and business which is not related to its functions as an undertaker ("non-regulated business").

[34] The notice period has now been extended to 25 years for all undertakers except Albion Water.

[35] Albion Water's intention to develop a new source was also referred to in a meeting between Albion Water and Ofwat on 26 March 1996 and in letters from Albion Water to Ofwat dated 16 April 1997 and 31 October 1997.

[36] We did however consult on the general principles we would use in determining bulk supply agreements in a letter to Regulatory Directors dated 21 November 1997 (RD 21/97), and on our proposal to grant Albion Water's Inset Appointment in a separate consultation paper dated 19 December 1997.

[37] [**]

[38] Although Dŵr Cymru and Albion Water agreed a price of 26p/m^3, the actual price charged by Dŵr Cymru in 1999/2000 equated to 25.8p/m^3 because the Producer Price Index had fallen before the Second Bulk Supply Agreement came into effect. The price was adjusted to reflect this.

[39] According to a document entitled "Shotton Paper Strategy, jrb 30/11/99" contained in documents provided by Pennon on 25 February 2003 in response to a Section 26 Notice.

[40] Water abstraction licences are issued by the EA under Part II Chapter III section 24(1) of the Water Resources Act 1991 ("WRA91").

[41] This was repealed by the Water Consolidation (Consequential Provisions) Act 1991, Section 3, Schedule 3, Part 1 and replaced by section 46(4) WRA91.

[42] Eversheds.

[43] Supra-normal profits are profits higher than an undertaking would earn in the long term in a competitive market.

[44] Letter from Albion Water's solicitors to Ofwat dated 21 December 2001.

[45] Letter from Albion Water's solicitors to Ofwat dated 14 May 2002.

[46] Letter from Albion Water to Ofwat dated 11 December 2000.

[47] Letter from Albion Water to Ofwat dated 11 December 2000.

[48] Letter from Albion Water to Ofwat dated 8 March 2001.

[49] Letter from Albion water's solicitors to Ofwat dated 5 July 2001.

[50] Letter from Albion Water's solicitors to Ofwat dated 21 December 2001.

[51] Letter from Albion Water to Ofwat dated 12 August 2003.

[52] Official Journal 372, 3.12.1997, page 5.

[53] Letter dated 5 July 2001 from Albion Water's solicitors to Ofwat.

[54] A "water resource zone" is defined by the Environment Agency as "the largest possible zone in which all resources, including external transfers, can be shared and hence, the zone in which all customers experience the same risk of supply failure".

[55] Case 27/76 *United Brands v EC Commission* [1978] ECR 207; [1978] 1 CMLR 429.

[56] OFT Guideline, "Assessment of Market Power" (OFT 415, September 1999) at paragraph 5.4.

[57] E-mail from Albion Water to United Utilities Water dated 6 December 2001.

[58] Albion Water did not disclose this correspondence during our investigation. In a letter of 13 June 2003, Dr. Jeremy Bryan (See endnote 59 below) explained that Albion Water had, at around the time of Ofwat's Section 26 Notice, been experiencing difficulties with its computer server as its hard drive

became full. The letter stated that some e-mails had therefore been deleted from the server at this time, although Dr. Bryan was unable to confirm whether this e-mail correspondence with United Utilities Water had in fact been deleted at that time. Dr. Bryan added that the server (which was subsequently replaced) might still have been readable, although he had not considered the cost of doing so to be warranted.

[59] The Managing Director of Albion Water, then a shareholder of Enviro-Logic, and now a shareholder of WaterLevel Limited which is Albion Water's current holding company.

[60] The review on which these figures were based, and the Bechtel Report, included the costs of installing an additional pumping station. The installation of a pumping station is not considered necessary in this case since United Utilities Water currently owns pumps with sufficient capacity to supply Dŵr Cymru with the water it needs for both Albion Water and [**]. If Albion Water or United Utilities Water were to supply Shotton direct, it appears unlikely there would be an increase in the volumes to be abstracted at the Heronbridge Abstraction Point and supplied to Shotton through the Ashgrove System or otherwise. In addition, the pumps at the Heronbridge Abstraction Point are not owned by Dŵr Cymru and do not form part of the alleged "essential facility".

[61] It is worth noting here that this approach is consistent with the average pricing that prevails in the water industry in England and Wales. When dedicated infrastructure is built to serve a specific customer or group of customers, that customer or group of customers is often required to pay for the capital costs.

[62] Letter from Albion Water to Ofwat dated 12 August 2003.

[63] An undated letter which we received on 21 August 2002.

[64] From Albion Water's solicitors.

[65] DETR publication (2000) "Water Industry Act 1999: Delivering the Government's Objectives ("the Secretary of State's Guidance").

[66] The National Assembly for Wales has not issued any guidance on charging matters equivalent to the Secretary of State's Guidance. However, in practice, in approving the charges schemes of undertakers wholly or mainly in Wales, we apply principles consistent with those set out in the Secretary of State's Guidance.

[67] See Section 2(3) WIA91.

[68] Dŵr Cymru informed us in a letter of 13 May 2004 that this was part of a longer term strategy to improve compliance with regulatory requirements. It stated that, "*unlike other undertakers with large users of non-potable water, Dŵr Cymru had not had a published large user non-potable tariff. Instead, customers had been charged according to individual special agreements, many inherited from the pre-privatisation era, which reflected different terms and conditions. The establishment of a published tariff to which all large users of non-potable water would migrate, either when their agreements expired or earlier if appropriate, was intended to improve transparency of Dŵr Cymru's charges and to meet objectives which had been set out by the regulator".*

[69] Please see paragraph 16 and footnote 18 for further information about "private suppliers".

[70] Case C – 7/97 *Bronner v Mediaprint* [1998] ECR 1-7791.

[71] Case C – 418/01 at paragraph 49.

[72] Case 26/75 *General Motors Continental NV v Commission* [1975] ECR 1367.

[73] At paragraph 11.

[74] At paragraph 12.

[75] Case 26/76 *United Brands v Commission* [1978] ECR 207.

[76] At paragraphs 390 and 391.

[77] OJ C 265/2 22.8.98.

[78] At the time Dŵr Cymru had provided an access price of 20 p/m^3 to Albion Water. It provided the First Access Price of 23.2 p/m^3 at a later date.

[79] LRMC is the change in total costs per unit change in output, over the long run.

[80] Please see paragraph 359 to 361 for details of other aspects of MD 163.

[81] A retail-minus methodology calculates prices in a "top-down" fashion, by subtracting costs avoided in providing a product from the retail price.

[82] Please see paragraphs 362 to 364.

[83] Calculating the charge for each customer based on the specific distance the water supplied to it travels from source and treatment works).

[84] Completion of the sale is deferred until the earlier of 31 March 2073 and the expiry of 21 years after the last survivor of the issue of King George V actually born before the date of his death.

[85] 43.9 p/m^3 minus the new Step 2 Figure of 27.3 p/m^3 (rather than the original Step 2 Figure of 27.9 p/m^3).

[86] MD 162 (April 2000) Common Carriage – Statement of Principles.

[87] Please see paragraphs 362 to 364.

[88] Taking into account the fixed and volumetric charges and assuming that the current volumes supplied to Shotton remain unchanged.

[89] (39)RAG2: Classification of infrastructure expenditure [draft version 2.0.3]; RAG3: Guideline for the contents of regulatory accounts [version 3.05]; and RAG4: Guideline for the analysis of operating costs and assets [version 4.01].

[90] "NWG Network Access Tariffs: Conceptual Analysis of "Access Pricing" in the UK Water Industry", a report for Northumbrian Water Group prepared by NERA (National Economic Research Associates), March 2000, London.

[91] "Access Pricing in the UK Water Industry: The Efficient Component Pricing Rule – Economics and the Law", a report for Northumbrian Water prepared by NERA (National Economic Research Associates), March 2001, London.

[92] Pages iii and iv.

[93] Page 7.

[94] In the context of the Costs Principle in WA03, the word "access" denotes "common carriage and wholesale", as it refers to both access to pipe networks, and access to wholesale supplies.

[95] Section 66 E of the Water Industry Act 1991, as amended by the Water Act 2003.

[96] Stranded assets are those (generally but not exclusively) capital assets (such as treatment works or boreholes) that are no longer needed, either wholly or partially, and which cannot be used elsewhere or in another context.

[97] "Extending opportunities for Competition in the water industry in England and Wales", July 2002 (paragraphs 187 to 191 in particular).

[98] Water Bill [Lords] in Standing Committee D, 16 October 2003 (afternoon).

[99] A cost-plus methodology calculates price in a "bottom up" fashion, by adding costs incurred in providing a product or service.

[100] See endnote 38 for an explanation of why the price in 2000/20001 was 25.8p/m^3 and not 26p/m^3,

[101] As noted above, Dŵr Cymru now offers the New Tariff of equivalent to 26.6 p/m^3 taking into account both the fixed and volumetric charges and assuming that the current volumes supplied to Shotton remain unchanged. The amount paid by Dŵr Cymru to United Utilities Water under the First Bulk Supply Agreement in 2003/2004 is 4.2p/m^3. Using either the ECPR or a more general "retail-minus" approach (or the Costs Principle), but this time assuming that the retail tariff was 26.6 p/m^3, the resulting access price would be approximately 22.4 p/m^3 (i.e. the retail price of 26.6 p/m^3 minus avoidable costs of approximately 4.2 p/m^3). As mentioned in paragraph 65 above, United Utilities Water has indicated that the price of 4.2p/m^3 reflects the recovery of capital expenditure resulting in an unusually high figure for this period. This demonstrates that there can be fluctuations both in the appropriate retail tariff and the appropriate avoidable costs which can impact on the access price resulting from an ECPR, or Costs Principle, calculation.

[102] See paragraphs 403 and 404.

[103] [2003] CAT 5 at paragraph 201.

[104] See *Merci Convenzionale Porto di Genova SpA v. Siderugica Gabrielli SpA* [1991] ECRI – 5889.

[105] United Utilities is a WaSC, Albion Water is a WoC, but vastly smaller than most other WoCs (apart from Cholderton and District Water Company Limited) as it only has one customer, Shotton.

[106] See paragraph 10 of Annex 1 for an explanation of "regulatory asset life".

[107] Taking into account the fixed charge that would apply and assuming the current volumes supplied to Shotton do not change.

[108] Although, the effect of including [**] in the NPV calculation is considered as one of the sensitivities in Table 5.

[109] Since 1999, the amount paid by Dŵr Cymru to United Utilities Water under the First Bulk Supply Agreement has been nearer to 3p/m^3 than the 4.2p/m^3 paid in 2003/2004. We understand from United Utilities Water that the 2003/2004 figure reflects capital expenditure carried out by United Utilities Water, resulting in an unusually high figure for this period.

[110] The operating costs do not make any allowance for a back-up supply in case there is an interruption in supply caused by, for example, a breakdown of the duplicate pipe and/or treatment works. If the option of a back-up supply is required, then the cost of putting in place this option would depend on a risk assessment involving a number of complex and uncertain issues, such as the likely number of occasions on which access to the back-up supply would be required and the length of time such interruptions would be likely to continue. If the back-up supply was ever required (i.e. the option was exercised) then there would be additional operating costs for supplying the water. We have not carried out a detailed risk assessment, but, assuming that any back-up supply could be provided through the Ashgrove System, we do not consider that the impact on the operating costs would be material.