Kirstin Baker CBE
Panel Inquiry Chair
Competition and Markets Authority
The Cabot
25 Cabot Square
London E14 4QZ

April 2025

Dear Kirstin,

PR24 Water Redeterminations – Investor Group Third Party Submission

(1) We are grateful for this opportunity to make a third-party submission to the Inquiry Group in relation to the PR24 water redeterminations. For the convenience of the Panel, we summarise our submissions in this letter, as more fully developed in the enclosed annexes.

(2) We represent a large ad-hoc group of over 100 financial institutions that are creditors of Thames Water Utilities Limited, amongst them the largest infrastructure investors and capital providers in the UK water sector (the "**Investor Group**"). Together, the Investor Group holds in excess of £13 billion of Thames Water's senior Class A Debt. Many of its members have significant debt holdings in other regulated UK water companies.

(3) PR24 is central to Thames Water's financial viability. The Investor Group's core concern is to conclude a successful restructuring of Thames Water through a market-led process, avoiding the disruption and consumer harm arising from a special administration regime ("**SAR**"). A factual primer on the Investor Group and the Thames Water restructuring is at **Annex 1**.

(4) Thames Water asked Ofwat to refer its final determination ("**FD**") to the CMA because of its serious flaws in light of the applicable legal duties. The sector's regulatory settlement does not support investability, deliver for consumers or the environment and, in Thames Water's case, prevented a market-led recapitalisation. Ofwat and Thames Water recognised the need for an 18 week pause to create space for a market-led solution and Thames Water turnaround plan. We hope that process will enable an outcome that avoids the need for a CMA redetermination. Should that not be possible, the Investor Group will clearly have an interest in the outcome of the redetermination.[1] For the avoidance of doubt, we do not speak for Thames Water or prejudge any further submissions it may make (as part of its own reference in due course or the reference for the other water companies).

(5) Our separate submission is limited and focused on the Investor Group's concern for the long-term financeability of the water sector. In sum, we endorse the National Audit Office's call for urgent regulatory action to secure investment for this sector.[2] We ask the CMA to create a prospectus against which prudent investors will lend or provide new equity.

[1] The Investor Group's interest in the redeterminations and its main points of agreement/difference are at **Annex 2.**
[2] NAO, *Regulating for investment and outcomes in the water sector*, 25 April 2025, ("**NAO Report**"), p11.

1. Summary

(6) **The UK water sector is £74.5bn in debt and needs £290bn more investment to deliver high-quality water and wastewater services to consumers and support the Government's growth objectives**.[3] To attract capital, PR24 must afford investors the chance of a fair return. UK water companies are expected to invest £104bn in totex in 2025-2030[4] and £260bn of enhancement investment in the period to 2050,[5] delivering up to 30 water supply projects including nine reservoirs and almost tripling the sector's current c.£99bn regulatory capital value.[6] There is wide and keen competition for this capital. Estimates predict a £615bn UK infrastructure investment shortfall across energy, transport and housing.[7]

(7) The National Audit Office calls for water regulators to act urgently to secure this investment:

> *"Defra and the water sector's regulators have not encouraged water companies to spend what they need to deliver the performance expected. The sector now faces significant environmental and supply challenges. To meet these challenges, it will need to attract investment and spend at a rate not seen before. The regulators must understand the scale of the challenge in terms of cost and deliverability and the condition of assets across the sector, ensure the sector raises the investment needed and meets government outcomes, and achieve value for money for bill payers."* National Audit Office, Regulating for Investment and Outcomes in the Water Sector, 25 April 2025, p.11.

(8) **PR19 did not create an investable settlement**.[8] All except three companies overspent their allowances, by an aggregate of £3.6bn in wholesale water and £600 million in retail water (2021-2024). Despite the overspend, companies' asset bases deteriorated and services suffered. The sector paid a net penalty of £300 million for not meeting Ofwat's AMP7 performance targets. As the National Audit Office observes, this deprived companies of funds that needed them the most to improve performance.[9] Ofwat reports pollution incidents increased for 9 out of 11 companies, despite targeting a 30% reduction. "*Almost all*" companies reported increases in internal sewer flooding incidents despite targeting 41% reduction.[10] Ofwat currently reports "*elevated concern*" for seven companies' financial resilience.[11] The evidence therefore suggests that the PR19 regulatory settlement was poorly calibrated.[12] Investors did not have a "fair bet."[13]

(9) For PR24 these concerns are more acute given the step-up in required investment and capital raising. The National Audit Office criticises the "*perceived decline in the stability and predictability of the regulatory framework"* for lenders, and rating agencies cite the regulatory

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[3] Total borrowing in the sector has increased from £68.3 billion as of 31 March 2023 to £74.5 billion as of 31 March 2024. Ofwat, *Monitoring Financial Resilience Report 2023-24*, November 2024, p17; NAO Report p.7.
[4] Ofwat, *Our final determinations for the 2024 price review - Sector summary*, p.3.
[5] Oxera, *Investability at PR24 - Final Report for Water UK*; 28 August 2024, p.2.
[6] *Ibid.,* p.18.
[7] *Ibid.*, p.28.
[8] *Ibid.,* p.6.
[9] NAO Report, paras 3.18-3.21.
[10] Ofwat, *Water company performance report 2023-24*, p.5.
[11] Ofwat, *Monitoring Financial Resilience Report 2023-24*, p.4.
[12] Yorkshire Water Final Submission at PR19, para 1.3.1; Northumbrian Water Final Submission at PR19, para 11.
[13] Oxera, *Investability at PR24 - Final Report for Water UK*; 28 August 2024, p10.

settlement as increasing the risk faced by the water sector,[14] driving rating downgrades, including at Thames Water, Southern Water, and South East Water.[15]

(10) **Expert regulatory economist evidence suggests the CMA's intervention is required for prudent investors to finance PR24**: The Investor Group has commissioned expert evidence from the following:

(i) **Dr Boaz Moselle and Dr Dermot Nolan** are expert economists and, respectively, a former managing director and the CEO of Ofgem. Mr Nolan was also formerly the Executive Chair of the Irish water and energy regulator. The Moselle/Nolan Report identifies errors in PR24's base and enhancement econometrics, incentives/penalties mechanisms and cost of capital.[16] They offer suggestions as to how these may be addressed;

(ii) **Prof. George Yarrow** of the independent Regulatory Policy Institute ("**RPI**"). Governments and regulators globally consult with the RPI and Prof. Yarrow on effective utility regulation. Prof. Yarrow's report identifies cross-cutting errors under PR24 and makes seven recommendations to address them in the CMA's redetermination;[17] and

(iii) **Thomas de la Mare KC** is one of the UK's most eminent public law and utilities regulation barristers. His submission identifies concerns with Ofwat's assessment and approach that should be considered by the CMA as part of its redeterminations.[18]

2. Financing Day-to-Day Operations

(11) **Base allowances skewed by methodological errors.**[19] PR24 base allowances rely on econometric modelling to determine companies' funding requirements for the basic maintenance and operation of water and sewage networks. All five disputing companies have identified the many ways in which Ofwat's modelling fails to correctly reflect their circumstances and this is also true for Thames Water. The base shortfall is demonstrated by the well documented deteriorating asset health and mains renewal rates despite persistent base overspend.[20] Dr Moselle and Dr Nolan demonstrate *inter alia* the modelling is not fit-for-purpose.[21]

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[14] NAO Report, p.11; Moody's, *Ofwat's draft determination increases sector risk*, August 2024, p.7; Moody's, *Reduced predictability of regulatory environment pressures credit quality,* November 2024; S&P Global, *U.K. Water Regulatory Framework Support, Low Financial Flexibility in Coming Regulatory Period Drive Rating Actions*, February 2025, page 3; Fitch ratings, *FD for AMP8 Will Be Crucial for De-Risking UK Water Sector*, November 2024; and NAO Report, paras 3.31 to 3.35.

[15] Moody's Ratings, *Moody's Ratings downgrades Thames Water's CFR to Caa3, stable outlook*, 23 January 2025; S&P Global, *Southern Water Services Ltd. 'BBB-' Debt Rating Remains on CreditWatch Negative Pending Full Commitment of Equity*, 1 April 2025; Moody's Ratings, *Moody's Ratings maintains negative outlook on South East Water; affirms Baa3 ratings*, 4 March 2025.

[16] The report of Dr Nolan and Dr Moselle is provided as **Annex 4**.

[17] The report of Professor Yarrow is provided as **Annex 3**.

[18] The submission of Thomas de la Mare KC and Dominic Howells is provided as **Annex 5**.

[19] For a general critique of Ofwat's approach to base cost modelling, *see* Thames Water (Third Party Submission), 22 April 2025, section 4.1; Southern Water, *Southern Water PR24 Redetermination Statement of Case*, 21 March 2025, chapter 2; Wessex Water, *Wessex Water PR24 CMA Redetermination Statement of Case*, 21 March 2025, paras 8.30-8.36; South East Water, *South East Water PR24 Redetermination, Statement of Case*, 21 March 2025, paras 4.18-4.33; Professor Yarrow Report (Annex 3), paras 47 to 84.

[20] NAO Report, p.9; Dr Nolan and Dr Moselle Report (Annex 4), e.g., para 2.4

[21] Dr Nolan and Dr Moselle Report (Annex 4), paras 3.1 to 3.53.

(i) The weight placed upon Thames Water's uniquely large and dense network skews the model across the sector, without any sound methodological basis.[22] Removing it from the wholesale water model increases Thames Water's allocation by ~£1bn;[23]

(ii) The model disregards the heterogeneity of density among water companies, in particular that Thames Water's area comprises two wholly different catchment areas: the dense urban London network and the more sparsely populated Thames Valley.[24] Conflating two distinct areas into a single modelled observation obscures the reality that they face very different cost drivers, substantially under-allocating their combined allowance. The impact is at least ~£273m for wholesale water and ~£42m for wastewater;[25] and

(iii) Ofwat misstates the evidence base for omitting a quadratic term for its wastewater model. The sector impact is material and under-allocates up to ~£154m for Thames Water.[26]

These errors may have led to systemic underfunding over prior PRs, compounding the challenges that companies like Thames Water now faces.[27]

(12) **Incomplete modelling hiding material unanticipated costs increases the risk to capital.** The disputing companies identify material differences in modelled costs from those they face in reality, including: (i) drawing an artificial line between base operations and new investment;[28] (ii) not accounting for regional differences in wages and other operating costs;[29] (iii) unrealistic productivity increases (a blanket 1% "frontier shift" unknown in the sector or broader economy)[30]; and (iv) increased labour costs from national insurance contributions.[31] Disputing companies claim at least £3.6bn for these and other base cost errors. We endorse the CMA's PR19 observations, not acted on in PR24, that modelling the past may be a poor guide to the future.

> *"Ofwat's cost assessment is backward looking and ... potential issues with capital maintenance may be forward looking. This is a complex issue, which, going forward, may become more important. We therefore suggest that Ofwat considers developing indicators to track this issue and to enable it to enhance its analysis with a forward-looking element that will assist in triangulating results from its econometric modelling of historic costs."*[32]

(13) Ofwat has disregarded the CMA's observations, despite tightening environmental standards and historic capital maintenance underfunding (forcing focus on "low hanging fruit" fixes rather than complex, costly works) which means modelling past costs will have masked the current realities of funding operations from base costs.

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[22] Dr Nolan and Dr Moselle Report (Annex 4) para 3.41.
[23] Dr Nolan and Dr Moselle Report (Annex 4) para 3.43.
[24] Dr Nolan and Dr Moselle Report (Annex 4) paras 3.27 to 3.38.
[25] Dr Nolan and Dr Moselle Report (Annex 4) para 3.37.
[26] Dr Nolan and Dr Moselle Report (Annex 4) para 3.20 to 3.26.
[27] Dr Nolan and Dr Moselle Report (Annex 4) para 3.38.
[28] E.g., Anglian Water, chapter E.1 section 3.1.3; Southern Water, chapter 3 section 4.3.
[29] E.g., Southern Water, chapter 2 section 3.1.2; Northumbrian Water section 5.4.2.
[30] For a general discussion on the frontier shift, *see* Thames Water (Third Party Submission), para 37(iii); Southern Water (Statement of Case), chapter 2 section 4.1.1; Anglian Water (Statement of Case), chapter E.1 section 3.4; Northumbrian Water (Statement of Case), section 5.4.1; South East Water (Statement of Case), paras 4.83-4.96; Professor Yarrow Report (Annex 3), paras 85 to 92.
[31] E.g., Anglian Water (Statement of Case), table 5; Wessex Water (Statement of Case), annex A9, para 2.57.
[32] CMA, *Anglian et al. Final Report*, 17 March 2021, para 4.293.

3. Financing New Infrastructure

(14) **Enhancement models' inadequate predictive power.** PR24 also uses econometric models rather than the companies' own estimates to help scale much-needed capital investment in storm overflow prevention, treatment plants, phosphorus removal, protection from industrial emissions and so on. Comparing predictions to outcomes, the evidence shows the models are not fit for purpose for Thames Water and others. This approach misstates the necessary funds for investment in nearly 50% of cases *by more than 30%*.[33] These modelled allowances represent at least £4.7bn in new investment. We are concerned that PR24 expects investment for this capex, not based on companies' estimates, but on models with predictive powers that are significantly at variance with real expenditure.

4. PR24 Enhancements Supply Chain Shock

(15) **Financing large-scale infrastructure programmes entails high delivery and execution risks.**[34] We are concerned that PR24 omits realistic consideration of the likely supply shocks and execution risks attendant on the massive infrastructure programme for which the sector is seeking finance. We agree with the National Audit Office[35] and rating agencies that the well-documented risks attendant on delivering large infrastructure programmes are insufficiently addressed:

> "*The whole sector will have to execute a much bigger capital program than in the past. This poses a significant execution risk to ensure the program can be delivered in due course and within the allowances... Each company will face significant pressure to secure its supply chain and financing accordingly and management to ensure the right execution of the plan in a timely fashion and within budget. Furthermore, they will face additional scrutiny from the regulator in AMP8 with the inclusion of price control deliverables, resulting in expanded oversight of delivery through increased reporting and the application of time-based incentives.*"[36]

(16) PR24 foresees totex doubling to £104 billion and enhancement more than trebling to £44.5 billion.[37] By contrast, the entire UK civil engineering project construction market is worth £40-45 billion p.a.[38] No modelling has been undertaken of the impact on labour and material cost inflation, shortages and consequent execution risk. Real price effect protection is partial, delayed, based on the wrong metrics, and curtailed by fictional "frontier shift" productivity increases (*de novo* infrastructure delivery programmes do not benefit from "learning by doing.") Cost and execution risk is amplified by prescriptive price control deliverables that disproportionately penalise delay or

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[33] Dr Nolan and Dr Moselle Report (Annex 4), para 4.36.
[34] E.g., Southern (Statement of Case), chapter 1 ("*Risk & financeability*"); Anglian (Statement of Case), chapter H.1 ("*Investability and Financeability*"); Thomas de la Mare and Dominic Howells Submission (Annex 5), paras 10-23.
[35] NAO Report, p.11.
[36] S&P, U.K. Water Regulatory Framework Support, Low Financial Flexibility In Coming Regulatory Period Drive Rating Actions, February 2025, p5-6
[37] Ofwat, *PR24 Key Dataset 2 Costs Past Delivery and Risk and Return data.xlsx*,,
[38] IBIS World: *Civil Engineering Project Construction in the UK - (2015-2030)*; *Mintel:* *UK Civil Engineering Market Report 2023*; Thomas de la Mare and Dominic Howells Submission (Annex 5), para 7.

non-delivery, no matter how legitimate the reasons.[39] No analysis has been done of the investment risk premium required to underwrite complex and costly large scale infrastructure projects.

5. The Opportunity for a Fair Return

(17) **Investment flows to a simple, balanced and predictable regulatory framework:** capital is attracted through a simple and well-understood regulatory framework. The regulator sets a funding allowance based on prices and clear priorities. Investors know that, with efficiency and innovation, the firm has an opportunity to outperform and earn a return. But this requires a division of labour between the regulator and the business. Micromanaged performance and complex layers of regulated targets inhibit the scope for efficient management and innovation.[40]

(18) We agree with the National Audit Office's criticism that regulatory complexity inhibits business focus, investment and sustainable delivery of capital projects in water.[41] Our analysis suggests that over-complexity was already the case at PR19, and PR24 compounds the complexity. PR24 sets an unprecedented 23 performance measures, unrealistic targets and disproportionate under-performance penalties.[42] Many double up with measures that environmental or other laws already require. Exacerbating downside risk, PR24 sets cliff-edge price control deliverables covering 77% of new infrastructure investment (worth over £30bn). These clawback substantially all allowed funds if there is a delay of more than a few months beyond the end of the price control period in completing a project, no matter how sensible the delay or how close the project is to completion. In some cases, targets appear calibrated to fail, for example, linking performance to the fiction that PR19 targets were achieved, when they were not, or to customer experience scores that evidence shows are untethered to actual performance.[43] These incentives and penalties are over-complex, mis-calibrated and entail a material downside bias for Thames Water and others,[44] which do not allow investors a fair chance for a fair return.[45]

(19) Ofwat's Quality and Ambition Assessment ("**QAA**") framework, developed for PR24, imposes significant penalties without a sound legal basis. The QAA purports to replicate functions that *could only properly* be discharged through clear ex-ante conditions; and does so without the necessary procedural safeguards. For example, Thames Water is expected to face QAA penalties exceeding £140 million based on Ofwat's subjective assessment of the business plan's "ambition". This regulatory approach not only creates material financial harm, but also effectively penalises Thames Water for *disagreeing* with Ofwat.[46] The QAA mechanism contributes to a regime that is asymmetrically skewed toward downside risk, further undermining investor appetite and sector financeability.

[39] Thames Water (Third Party Submission), section 7; Dr Nolan and Dr Moselle Report (Annex 4), paras 5.149 to 5.165; Professor Yarrow Report (Annex 3) paras 103 to 106; Thomas de la Mare and Dominic Howells Submission (Annex 5), paras 38 to 41.
[40] S&P Global, *UK Water Regulatory Framework Support*, 18 February 2025, p.7; Southern Water, Chapter 1 section 7.2.1; Northumbrian Water, section 3.4; Anglian Water, para 11; Professor Yarrow Report (Annex 3), paras 32 to 37.
[41] NAO Report, p.9.
[42] Dr Nolan and Dr Moselle Report (Annex 4), paras 5.14 to 5.35; NAO Report, paras 3.17 to 3.21.
[43] Dr Nolan and Dr Moselle Report (Annex 4), paras 5.59 to 5.100.
[44] Annex 2, section 6. *See* also Professor Yarrow Report (Annex 3), paras 93 to 106.
[45] Dr Nolan and Dr Moselle Report (Annex 4), paras 5.14 to 5.165.
[46] Annex 2, section 5.

6. High Operational Leverage and Risk of Financial Distress Lead to Higher Cost of Capital[47]

(20) **An industry characterised by soaring fixed costs and financial distress will need to offer financial returns commensurate with the risks**. The more than trebling of new infrastructure investment and resources under PR24 increases financial risk.[48] It ramps up the operational gearing of the water companies, increasing the sector's capex to opex ratios by 60%.[49] Ofwat's reliance on historical data to calculate the cost of equity and, in turn, the WACC is therefore not appropriate.[50] Standard economics (and the CMA in its PR09 and PR14 redeterminations[51]) incorporates this risk in calculating fair returns, a step omitted by PR24[52]- even though it would not depart from the notional company paradigm.[53] Our analysis shows an almost £800m industry-wide shortfall in allowed returns.[54]

(21) **PR24 calculates the capital of a notional company in robust financial health.**[55] Ofwat's financial resilience report does not show this to be the case. Ten water companies' financial positions give rise to elevated concern, and there is a realistic possibility of a SAR of Thames Water (and potentially others), with the resulting potential for significant disruption and burden on the public purse with worse outcomes for consumers and the environment.[56] Our analysis sets out the regulatory options that should be considered to ensure companies like Thames Water remain financeable despite these risks.[57]

(22) The financeability duty entails broad discretion. But that discretion is bounded. If the notional company is not financeable, and the counterfactual is one of potential SAR or a perpetuated downward spiral of worsening performance, investors naturally require a higher rate of return.[58] In these situations, the financeability duty requires consideration of the company's actual finances.[59]

7. Support for the Disputing Parties and Reservation of Rights

(23) For the convenience of the CMA, we set out in **Annex 2** certain of the submissions of the disputing companies (without limitation) that the Investor Group supports from its perspective as investors in Thames Water.[60]

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[47] Cost of Capital is further addressed in Dr Nolan and Dr Moselle Report (Annex 4), section 6.
[48] Section 4 above; Dr Nolan and Dr Moselle Report (Annex 4), paras 6.1 to 6.3; and, e.g., Anglian, para 372; Thomas de la Mare and Dominic Howells Submission (Annex 5), paras 10 to 23.
[49] Dr Nolan and Dr Moselle Report (Annex 4), para 6.11.
[50] Dr Nolan and Dr Moselle Report (Annex 4), paras 6.5 to 6.24 and Annex A.
[51] CMA redetermination for Bristol Water at PR09, Appendix N, para 129; PR14, para 10.152. In PR19, the CMA considered an uplift for Bristol Water but decided not to include it due to a fact-specific finding on Bristol Water's beta, *see* para 9.1102.
[52] Dr Nolan and Dr Moselle Report (Annex 4), paras 6.15 to 6.24.
[53] Dr Nolan and Dr Moselle Report (Annex 4), para 6.23.
[54] Dr Nolan and Dr Moselle Report (Annex 4), paras 6.38 to 6.39.
[55] Dr Nolan and Dr Moselle Report (Annex 4), paras 7.26 to 7.40
[56] NAO Report, page 11.
[57] Dr Nolan and Dr Moselle Report (Annex 4), paras 7.8 to 7.25; Professor Yarrow Report (Annex 3), para 122.
[58] Dr Nolan and Dr Moselle Report (Annex 4), paras 7.32 to 7.40.
[59] Dr Nolan and Dr Moselle Report (Annex 4), paras 7.26 to 7.31.
[60] For the avoidance of doubt, this is not a comprehensive view or does not reflect all the points that the Investor Group may wish to make and which are specific to Thames' own FD for PR24.

(24) PR24 is a critical price control both for Thames Water and for the wider water industry. The five disputing companies' statements of case have raised a number of issues that are of direct relevance to Thames Water and, by extension, to the Investor Group. Should Thames Water's final determination ultimately be referred to the CMA, it is essential that the CMA's consideration of the issues raised in the current redeterminations should not prejudice or predetermine the outcome of Thames Water's redetermination. Emphasising that it does not speak for Thames Water, nevertheless the Investor Group has a clear interest in any redetermination of Thames Water being conducted in a way that fully addresses Thames Water's situation and circumstances. The consideration of those issues should not suffer any prejudice by virtue of its request for a redetermination being referred to the CMA later than those of the other water companies.

(25) With that context in mind, the Investor Group makes these submissions whilst reserving its right to make further submissions generally and without prejudice to its right to make submissions to the CMA in relation to Thames Water's case, at the point that it is relevant.

(26) It is vital that the CMA set the scope of its approach to considering the five requests for redetermination referred to it in a way that responds only to the cases before it and does not pre-empt or foreclose a case that it knows is likely to come before it subsequently for Thames Water. Therefore, the approach document adopted by the CMA in relation to the submissions of the disputing companies should be expressed to be limited in the sense that it is the approach of the CMA to those five cases; and is does not preclude consideration of a different or wider approach on the facts of different cases. This is particularly important also in relation to industry-wide approaches and data points available to the CMA at the relevant time, as each redetermination needs to be considered in its own right.

8. Next Steps

(27) We are grateful for this opportunity to make submissions on the water sector's financeability. We should be pleased to engage further with the CMA on any of the issues raised in our submissions and address any questions you may have, and would be happy to arrange for Prof Yarrow, and/or Dr Moselle and Dr Nolan to present their findings to the CMA should this be helpful.

Yours sincerely,

[redacted] [redacted] [redacted]

Skadden Arps Slate Meagher & Flom LLP | Akin Gump LLP | Towerhouse LLP

ANNEXES

- Annex 1: History and status of Thames Water's restructuring
- Annex 2: The Investor Group's interest in these redeterminations and its submissions on the statements of case of the five disputing companies

- Annex 3: Report of Professor George Yarrow, Regulatory Policy Institute
- Annex 4: Report of Dr Nolan and Dr Moselle, Compass Lexecon
- Annex 5: Submission of Thomas de la Mare KC and Dominic Howells