

INVESTOR GROUP OBSERVATIONS ON THE CMA'S APPROACH AND PRIORITISATION DOCUMENT ("Approach Document")

PR24 REDETERMINATIONS

Summary

- (1) The Investor Group¹ is grateful for the CMA's transparency in setting out its intended approach to each disputing company's redetermination and takes this opportunity to respond to the Approach Document. We provide three short observations from the perspective of leading lenders and investors in the sector. The Investor Group's submissions are its own, separate to any that Thames Water may make.²
- (2) In sum, the Investor Group:
 - (A) welcomes the CMA's decision to address key areas that underpin a stable investment framework for the water sector;
 - (B) recommends a targeted examination of base cost modelling. The evidence shows that Ofwat's base cost models are skewed, amongst other things, by inclusion of companies like Thames Water that do not have sufficiently comparable characteristics to other water companies; and
 - (C) considers it essential that the CMA limits its intended approach to the disputing companies' statements of case. As the CMA rightly notes, it is only able to address the facts and arguments of the disputing companies before it. In the event of a Thames Water referral, it may be necessary and appropriate to modify the approach and/or Thames Water may raise additional matters, which will need to be appropriately prioritised taking into account Thames Water's specific circumstances and arguments.

Promoting a Stable Investment Framework

- (3) **Investment flows to a simple, balanced, and predictable regulatory framework.** The Investor Group endorses the recent findings of the National Audit Office, and the interim report of the Independent Water Commission ("**Cunliffe Commission**") that *"to attract such long-term investors, willing to make the substantial future investment we need, risks also need to be lower than they are presently."*³ The Investor Group supports the CMA's decision to address areas that are key for the investment framework, including base and enhancement costs, outcomes (including PCDs, ODIs, and PCLs), the allowed return, and financeability.⁴

¹ We adopt the defined terms in our initial submission of 29 April 2025. The Investor Group is an ad-hoc group of over 100 financial institutions that are creditors of Thames Water Utilities Limited ("**Thames Water**"), amongst them the largest infrastructure investors and capital providers in the UK water sector.

² 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).

³ Independent Water Commission ("**Cunliffe Commission**"), Interim Report, 3 June 2025, page 4; National Audit Office, Regulating for Investment and Outcomes in the Water Sector, 25 April 2025, page 11.

⁴ CMA, Approach Document, paragraphs 41, 54-58, 68-74, 75-79, and 90-91.

- (4) For the same reason, we consider the CMA should reconsider its proposed 0.5% materiality threshold⁵. As this redetermination process has shown, there are many contested issues subject to dispute. Deprioritizing on the basis of such a high materiality threshold risks there being no effective route of challenge for regulatory decisions which – in the aggregate – may substantially exceed the 0.5% threshold. This is a sector that attracts investors to stable but relatively low returns compared to other investments. The lack of accountability for a potentially long tail of regulatory decisions, which may – in aggregate – be of highly material value, creates damaging regulatory uncertainty that deter investors.

Ensuring that Econometric Models are Fit-for-Purpose

- (5) **Ofwat’s base cost modelling is not a safe basis for investment. It is skewed by masking errors and “unicorn” effects.** Comparative econometric modelling functions poorly in regulating highly differentiated businesses. Dr Nolan and Dr Moselle’s (Compass Lexecon) Report has identified serious flaws in Ofwat’s econometric models, which suggest systemic under-funding of the water sector.⁶ The concerns arise in both base and enhancement modelling. **The base model** creates false predictions resulting from: (i) the “unicorn” effect of Thames Water’s inclusion distorting the model because of its unique qualities; and (ii) masking of highly differentiated network densities.⁷ **The enhancement models’** predictive power is only ~30-50% for most models examined by Dr Nolan and Dr Moselle.⁸

- (6) **The failures of the models are well observed by the Cunliffe Commission:**

“Ofwat’s current approach places excessive reliance on econometric modelling based on (largely historic) sectoral benchmarking and does not sufficiently integrate an appraisal of the individual circumstances of water companies in England and Wales.”

“[D]ifferences between water companies limit the weight that can be put on a modelled comparative benchmarking approach when assessing whether individual company costs are reasonable, whether the company is improving efficiency, and whether the company’s performance overall is satisfactory.”⁹

- (7) **The integrity of base modelling is essential to investability.** The Approach Document refers to Wessex Water’s proposal to replace Ofwat’s base models with a ground-up costs assessment.¹⁰ It states this should be deprioritised *inter alia* as “*econometric benchmarking is a well-established practice.*” The Investor Group recommends that examination of base modelling should be taken forward in the CMA’s review as suitable for a targeted intervention. The base cost models are responsible for ~£40 billion in base costs.¹¹ The integrity of the models directly affects the financial

⁵ CMA, Approach Document, paragraph 34.

⁶ Investor Group, Third-Party Submission, Annex 4.

⁷ Investor Group, Third-Party Submission, Annex 4, Section 3.

⁸ Investor Group, Third-Party Submission, Annex 4, paragraph 4.65.

⁹ Cunliffe Commission, Interim Report, 3 June 2025, paragraphs 178 and 181.

¹⁰ CMA, Approach Document, paragraphs 46, stating, in response to Wessex Water, that it does not propose to “*set aside the results of the models and set its base costs based on the ‘bottom-up’ evidence.*”

¹¹ Investor Group, Third-Party Submission, Annex 4, Section 3, Tables 3 and 5.

credibility of the sector. The risk of material distortions drives up the risks and costs of any investment.

- (8) A targeted intervention would allow the CMA to address these distortions. This could involve excluding extreme outliers from the analysis and taking outliers' actual costs as the point of departure, applying forensic rather than statistical analysis to determine whether any efficiency adjustments are needed.¹² This aligns with the Cunliffe Commission's recommendation of "*much greater company specific assessment and engagement.*"¹³
- (9) **Base modelling intervention is an important adjunct to the CMA's examination of the model drivers of both base and enhancement.** The Investor Group supports the CMA's decision to consider the set of explanatory variables used in Ofwat's models,¹⁴ and the reliability of models more broadly.¹⁵

The CMA's Approach In These Cases Must Not Pre-Empt a Thames Water Redetermination

- (10) It is clear from the CMA's Approach Document that it is confined to the five disputing companies and does not make any statement that constrains the approach to be taken should a redetermination of Thames Water take place. It follows that any deprioritisation for the five disputing companies is limited only to those companies' redeterminations. This aligns precisely with the point that the Investor Group made in its initial submission about the need to ensure each redetermination is focused and properly takes into account the situation of that licensee and other elements of the CMA's process at that point. It stands to reason, therefore, that the CMA's approach, and the areas the CMA is deprioritising, in relation to the five disputing companies do not pre-empt any future redetermination for Thames Water in relation to PR24. Each case should be considered on its own facts and legal arguments. We consider this is particularly important for water companies experiencing serious financial distress. The Investor Group reserves its rights to make further submissions including in the following areas in the event of a Thames Water redetermination.
- (11) **Financeability must include consideration of the risk premium associated with companies in financial distress.** The Investor Group supports the CMA's decision to address the balance of risk and return, and to carry out an independent assessment of WACC, not deprioritise any of the parameters, and use up-to-date market and other data.¹⁶ In this context we believe it is critical to consider the increased cost of capital faced by companies in distress, which goes beyond Thames Water and affects many water companies. Ofwat has identified concerns about the financial resilience of 10 of the 16 major water companies.¹⁷ The National Audit Office recently reported that "[c]redit-worthiness affects the cost of debt, and this has gone up relative to other sectors for

¹² Investor Group, Third-Party Submission, Annex 4, paragraphs 3.50 et seq.

¹³ Cunliffe Commission, Interim Report, 3 June 2025, paragraph 184.

¹⁴ CMA Approach Document, paragraph 43.

¹⁵ CMA, Approach Document, paragraph 45. Also see Cunliffe Commission, "*there are limits to how precise and accurate a benchmarking framework and econometric tools can be and the extent to which it can be relied upon*", paragraph 178.

¹⁶ CMA, Approach Document, paragraphs 78-79, 82.

¹⁷ Ofwat, Monitoring Financial Resilience Report 2023-24, page 7.

2025–2030.”¹⁸ The Cunliffe Commission noted stakeholder concerns about a “doom loop”, i.e. “companies that struggle in performance are benchmarked against higher performing companies, resulting in lower funding, and limiting their ability to turn around performance”.¹⁹ This is an important element of the financeability assessment.

- (12) **Deprioritisation of Ofwat’s business plan QAA.** The Approach Document proposes to deprioritise Ofwat’s QAA on the basis that it was unchallenged by the disputing water companies,²⁰ despite significant criticisms of its distortive effects.²¹ From an investor perspective, the QAA penalty is a disincentive to investment. It is disproportionate to its stated aim and cuts across the good faith efforts of companies to present business plans identifying their real needs, if they fear Ofwat may take a different view.²² The Investor Group agrees with the Cunliffe Commission’s observations that this type of penalty is counter-productive: “*Whilst the penalties and fines were for underperformance relative to regulator expectations as well as wrongdoing, there remains the question of how constructive they are in turning around poor performance at a time when the industry needs to attract significant investment.*”²³ To the extent that the QAA penalty is raised in any Thames Water referral, we consider it important that it be examined.
- (13) **Increasing National Insurance contributions are significant.**²⁴ Labour costs represent a significant share of costs for water companies. As of 1 April 2025, water companies will have to bear statutorily increased contributions, affecting not only direct labour and subcontract costs but the entire supply chain to the tune of approximately £1,000 per employee.²⁵ Ofwat’s position does not appear to account for any likely increase in headcount water companies may require over the coming period and therefore may not consider adequately the increase in labour costs that will be borne. The issue would be further exacerbated when considering the position of Thames Water, which is the biggest water and wastewater company in the UK and operates in the highest-paying part of the UK, London. National Insurance contributions are highly likely to be material in a potential Thames Water redetermination and the CMA would need to consider this point afresh in the event of a Thames Water referral. Given the unavoidable nature of the cost, we would expect this to be addressed outside of any materiality threshold.
- (14) **Next steps.** The Investor Group looks forward to continued engagement with the CMA and would value the opportunity to make further submissions on any of these points should this be helpful.

¹⁸ National Audit Office, Regulating for Investment and Outcomes in the Water Sector, 25 April 2025, paragraph 22.

¹⁹ Cunliffe Commission, Interim Report, 3 June 2025, paragraph 142.

²⁰ CMA, Approach Document, paragraph 93(a).

²¹ Notably, Anglian Water Statement of Case, paragraphs 11, 95, and 344(i).

²² Wessex Water, Statement of Case, paragraphs 2.31 and 8.10. The QAA, according to Wessex Water, discourages companies from requesting additional allowances that are not expressly provided by Ofwat. For example, Wessex Water’s base cost request was rejected on the condition that it was required to reassess the “*scale and efficiency of its cost requests*” to move out of the “inadequate” category.

²³ Cunliffe Commission, Interim Report, 3 June 2025, paragraph 180.

²⁴ CMA, Approach Document, paragraph 53.

²⁵ Wessex Water, Statement of Case, Annex A9, paragraph 2.57. *See also*, Anglian Water, Statement of Case, table 5.