



**Thames Water Utilities Limited**

PR24 CMA Redetermination

**Third Party Submission in Response to the CMA's PR24 Approach and  
Prioritisation document**

Submitted 11 June 2025

## 1 Introduction

- (1) This submission sets out the views of Thames Water Utilities Limited ("**Thames Water**" or the "**Company**") on the CMA's PR24 Approach and Prioritisation document published on 28 May 2025 (the "**Approach Document**"). We do not underestimate the magnitude of the task that the CMA faces in disposing of an unprecedented number of parallel redeterminations in a fair, efficient and proportionate manner, shaping the approach to be taken in these cases. With that context, we welcome the opportunity to comment on the CMA's proposal for approaching the redeterminations.
- (2) As detailed in our third party submission of 22 April 2025 ("**Third Party Submission**"),<sup>1</sup> on 14 February 2025 Thames Water announced that it had asked Ofwat to refer its Final Determination ("**FD**") to the CMA for redetermination. On 18 March 2025, Thames Water and Ofwat agreed to defer Thames Water's reference to the CMA for up to 18 weeks.
- (3) As highlighted in the Third Party Submission, Thames Water agrees with a significant proportion of the points raised by the disputing companies. If our price control is ultimately redetermined by the CMA, those issues would need to be considered on their merits in relation to Thames Water. Equally, however, there will be important areas of differentiation given the unique circumstances of Thames Water. As the CMA will be aware, Thames Water is experiencing well-publicised operational and financial difficulties, and we are in the process of turning our business around and attracting new capital and deliver on our business plan. We are also subject to region-specific challenges and costs by virtue of operating in London and which, as the interim report by the Independent Water Commission, recognises are not reflected in Ofwat's current approach which "*places excessive reliance on econometric modelling based on (largely historic) sectoral benchmarking*".<sup>2</sup>
- (4) Thames Water considers that it is imperative, particularly noting the exceptional nature of the Company's present position, that it is clear that the CMA's approach to, and consideration of, the issues for the five disputing companies does not in any way prejudice or predetermine any redetermination by the CMA in relation to Thames Water. Should Thames Water's FD be referred to the CMA, we anticipate that the CMA would adopt a separate approach document for Thames Water that would reflect the specific circumstances at that time, address the particular issues raised in our Statement of Case, and consider which issues to prioritise in light of the facts of that case, including the reduced procedural complexity (compared to a process involving five disputing companies).
- (5) Without prejudice to that position, or any future submissions in a redetermination for Thames Water, our submission is intended to assist the CMA by providing observations in relation to certain aspects of the Approach Document.
- (6) The remainder of the document is structured as follows:
  - (i) Approach to prioritisation (**Section 2**)
  - (ii) Other aspects of the CMA's approach (**Section 3**), namely:
    - (i) data driven approach to variable selection (**Section 3.1**); and
    - (ii) the treatment of new evidence, data and information (**Section 3.2**).

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<sup>1</sup> Thames Water Utilities Limited, PR24 CMA Redetermination Third Party Submission in Response to Disputing Companies' Statements of Case (22 April 2025).

<sup>2</sup> Independent Water Commission, Interim Report (3 June 2025) (the "**Interim Report**"), paragraph 181.

## 2 Approach to prioritisation

- (7) Thames Water is cognisant that adopting a proportionate approach is consistent with the CMA's overriding objective. Having said this, the Approach Document rightly recognises that the CMA must take a fresh look at matters on their own merits in accordance with its statutory duties. We expect that in approaching its task the CMA will be mindful that this is not an "errors" based legal appeal framework when considering whether departures from Ofwat's established approaches and methodologies are warranted.
- (8) Similarly, we believe that the CMA should consider whether the overall balance of risk is an appropriate one, when considered holistically. The CMA has stated that it will consider the balance of risk "at source", specifically in the context of the Aggregate Sharing Mechanisms ("**ASM**") and the Outturn Adjustment Mechanism ("**OAM**").<sup>3</sup> Thames Water considers that the CMA should look at the overall balance of risk "in the round": with the ASM and the OAM assessed in the context of the different constituent parts of the price control and how they fit together.
- (9) While we are conscious of the fact that the Approach Document rightly does not purport to apply to Thames Water, we highlight three concerns with the principles of prioritisation set out at paragraph 34 of the Approach Document. These go further than the general considerations set out in the CMA Guide<sup>4</sup> (and also the approach document at PR19) and we consider may not always best serve the overriding objective:
- (10) First, we do not consider that a blanket limit of 0.5% of totex should be applied as a de minimis threshold to deprioritise issues. The application of a specific value threshold is not contemplated in the CMA Guide.<sup>5</sup> Where the CMA and the Competition Commission have made reference to a specific threshold for assessing whether to intervene in an appeals context based on materiality (e.g. energy price control appeals), the threshold cited in these cases is 0.1%.<sup>6</sup> We do not believe it to be justifiable to apply a materiality threshold that is five times higher in the context of water redeterminations than that which is used to assess materiality in an appeals context. In any event, any materiality threshold that is imposed needs to be flexible enough to accommodate the strategic importance of certain (otherwise "de minimis") matters, for example where the CMA's decision could set precedent for key policies or methodologies moving forwards.<sup>7</sup> The CMA has itself made clear that this is not a bright line test and also recognised the cumulative impact of smaller errors.
- (11) With respect to Ofwat's failure to fund the increase in National Insurance Contributions ("**NICs**") (raised by Southern Water and Wessex Water) specifically, we believe that this flaw is material and, in any case, do not believe that materiality should be a determining factor. From 1 April 2025, water companies will have to bear increased NICs due to statutory developments, of up to £1,000 more per employee. For Thames Water, the largest water

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<sup>3</sup> Approach Document, paragraphs 86 to 88.

<sup>4</sup> CMA, Water References: Competition and Markets Authority Guide CMA205 (10 December 2024).

<sup>5</sup> Ibid.

<sup>6</sup> See CMA Response: Clarification of our position on potential Energy Licence Modification Appeals (30 October 2019): "*In the past, the CC made reference to "0.1%" as a size of error which was clearly not material and this has been referred to in subsequent cases. It is clear both from the relevant decision and also from the context that this is not intended to be a "bright line" test and is to be considered in each case alongside other factors.*"

<sup>7</sup> See *Northern Powergrid (Northeast) Plc and Northern Powergrid (Yorkshire) Plc v Gas and Electricity Markets Authority: Final Determination* para. 3.83; *British Gas Trading Limited v The Gas and Electricity Markets Authority: Final determination* para. 3.61; *BT v Ofcom and TalkTalk v Office of Communications* [2016] para 2.35, *CityFibre Infrastructure Holdings plc v Office of Communications* [2017] para 2.28; and *Carphone Warehouse Group plc v Office of Communications (LLU)* [2010] paras 1.59 onward.

and wastewater company in the UK covering the highest-paying areas within the country, these increased labour costs will have an even more significant impact than for other water companies. Ofwat has also acknowledged that NICs costs are not funded and noted that “*we have thought about an approach to determining a potential cost adjustment, and would be happy to discuss with the CMA if helpful*”.<sup>8</sup> Given Ofwat acknowledges that a cost adjustment may be merited and is amenable to determining a solution with the CMA, we believe this could easily be fixed and do not consider it proportionate or consistent with the overriding objective to deprioritise this issue on the basis of materiality alone.

- (12) Second, we have concerns with deprioritising issues where Ofwat has argued that the relevant issue will be addressed in a reasonable period through an alternative route, e.g. Ofwat’s roadmap for enhancing asset health understanding (which Ofwat notes has been developed in response to the CMA’s suggestion in its PR19 redeterminations that Ofwat should “develop forward looking capital maintenance and asset health indicators”<sup>9</sup>). Disputing companies cannot have certainty that an alternative process will deliver an outcome which addresses their concerns in a reasonable timeframe (as shown by the fact that Ofwat’s roadmap for enhancing asset health understanding was published almost 3 years after the CMA’s PR19 redeterminations were published). Moreover, depending on the legal basis for the alternative process, companies may have much more limited means of legal redress (e.g. companies may not be able to appeal the outcome of the alternative process to the CMA and would have more limited legal recourse by way of standard judicial review).
- (13) Third, we do not agree with deprioritising an issue because it reflects prior regulatory practice. Just because regulatory practice is well established does not mean that this is appropriate or suitable in all contexts and circumstances, and – to the extent that the CMA does seek to derive comfort from prior regulatory practices – this does not remove the right of each individual company to challenge that practice as unsuitable for it in accordance with that company’s legal right to seek a full redetermination of its price control. While we appreciate that the CMA cannot fix fundamental, structural challenges facing the sector, the CMA should consider whether regulatory practice delivers an outcome which is correct on its own merits for PR24 and consistent also with the statutory duties.
- (14) In particular, we note that: (i) it is common ground that AMP8 will need to represent a paradigm shift in investment levels; and (ii) all disputing companies have highlighted that the regulatory approach adopted at PR19 resulted in an excessively challenging price review with financial and operational consequences for the sector. To take one example, the CMA proposes not to look behind base econometric modelling because “*econometric benchmarking is a well-established practice*.”<sup>10</sup> In the Interim Report, the Cunliffe Commission has identified “*excessive reliance on econometric modelling based on (largely historic) sectoral benchmarking*” which does not adequately reflect differences between water companies as a principal case of failure of Ofwat’s regulation.<sup>11</sup>
- (15) Given the unique circumstances facing Thames Water, if its FD is referred to the CMA, we expect that the CMA will need to consider whether changes to regulatory practices are

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<sup>8</sup> Ofwat, Ofwat’s response to disputing companies’ submissions on other companies’ statements of case (14 May 2025), paragraph A1.4.

<sup>9</sup> Ofwat, PR24 final determinations: Roadmap for enhancing asset health understanding in the water sector (December 2024), section 1.

<sup>10</sup> Approach Document, paragraph 46.

<sup>11</sup> Interim Report, paragraph 181.

necessary when regulating a company in financial and operational turnaround. This is consistent with the recognition in the interim report of the Independent Water Commission that the regulatory regime “*must be fundamentally strengthened and rebalanced*”, and to support such a company, a “*more fundamental shift is needed*”.<sup>12</sup> For instance, given the nature of its operating region and its network of assets, Thames Water sits in an exceptional and unique position when compared to other water and sewerage companies making an undue reliance on econometric benchmarking particularly unsuitable for it.

- (16) As noted above, in the event of a reference of Thames Water’s FD, the CMA would need to consider prioritisation from first principles, including where (i) new issues are raised in the Company’s Statement of Case; and (ii) where issues have been deprioritised for the other disputing companies but have a material impact and would need to be prioritised for Thames Water. For instance, the Approach Document explains that the Quality and Ambition Assessment (“**QAA**”) is an issue that it does “*not intend to reconsider as [it was] unchallenged*”.<sup>13</sup> This is a material issue for Thames Water, given that it is the only company to have a QAA penalty imposed, comprising a -30bps (equivalent to £141 million) financial deduction from the rate of return and a 60:40 cost sharing rate on base expenditure.

### 3 Other aspects of CMA’s approach

#### 3.1 Data-driven approach to variable selection using econometric tools for base cost modelling

- (17) We support the CMA’s decision not to deprioritise the base cost models. The models determine a large share of totex. Imprecision in their specification can have very material implications for companies’ totex allowance. It is therefore crucial that the arguments raised by the disputing companies are thoroughly and carefully considered in this area.
- (18) The CMA indicated its intention to explore the LASSO as a technique for reconsidering the set of explanatory variables used in the models, following representations by two of the disputing companies. We do not think that the LASSO technique is suitable for considering the disputing companies’ arguments concerning the models’ cost drivers.
- (19) The LASSO technique is typically used in datasets where the number of potential explanatory factors is large (often exceeding the number of observations). In these situations, the LASSO optimisation is a pragmatic technique that removes variables whose explanatory power is low (relative to the size of their coefficient), such that a smaller set of relevant explanatory variables remains.
- (20) However, this is not the situation for the base cost models at PR24. The number of explanatory factors in Ofwat’s price control models is relatively small.
- (21) Crucially, it is worth distinguishing between *types* of cost drivers and *measures* of a cost driver. Ofwat employs a small number of well-established types of cost drivers in its models, such as scale, density, complexity, and topography. For each type of driver, Ofwat may use several measures, each in a separate model, in a triangulation approach (for example, the use of average pumping head and booster pumping stations, each in a separate model, as two measures of a topography variable).

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<sup>12</sup> Interim Report, paragraph 183.

<sup>13</sup> Approach Document, paragraph 93(a).

- (22) Thus, there are two distinct selection processes, type selection and measure selection. The LASSO can, in principle, be useful for the type selection process, where many potential types exist.<sup>14</sup>
- (23) However, the types of variables included in the models have been subject to substantive consultations to achieve stakeholder consensus and regulatory acceptability at PR19 and PR24. In their Statements of Case, the disputing companies do not appear to contest the types of variables in the models. Instead, the disputing companies have raised nuanced arguments contesting specific measures used to represent particular types of variables. For example, the disputing companies are not contesting that topography affects costs but the appropriate measure to represent topographical challenges.
- (24) We do not consider that the LASSO technique is suitable in this context. The nature of the specification questions raised by the companies is not aligned with a standard application of LASSO, which is to identify and remove specific drivers (usually amongst a long list of drivers) whose contribution to the model is not meaningful (that is, to create so called 'approximate sparsity').
- (25) The question being asked is not whether the variable is meaningful, but whether a specific measure is appropriate to represent a meaningful type of variable. Approximate sparsity, which effectively defines the use of LASSO, does not accurately characterise the question which needs to be resolved. The arguments in favour of, or against, specific measures are often based on characteristics that the LASSO would not consider, such as the data quality of the particular measure, rather than whether they make a meaningful contribution.<sup>15</sup>
- (26) We also note that one of the weaknesses of LASSO is that it struggles to handle collinear variables, such that the removal of collinear features from a model can be arbitrary. Since the precise specification of a model can have very material implications for companies, arbitrariness in decision-making should be minimised.
- (27) For example, the LASSO technique relies on a tuning parameter, known as "lambda", which controls how sparse the final model is – i.e., how many variables are retained. Importantly, lambda also influences the estimated coefficients even when the selected variables are the same. The choice of lambda is therefore critical. While several methods exist to guide its selection, the process inevitably involves some degree of arbitrariness. This is especially so when working with relatively small datasets, such as the panel data available to Ofwat (and now the CMA), which are too limited to allow for a meaningful "hold-out" dataset (i.e., data set aside at the outset in order later to be used as a testing ground for competing models).
- (28) There may be a balance to be struck between mechanistic/automated assessment and human judgment. When deciding between competing measures of a cost driver based on the type of arguments raised by the disputing companies in the present case, we consider that human judgment is required to evaluate their nuances.

### **3.2 Treatment of new evidence, data and information**

- (29) We agree with the CMA that it is consistent with the overriding objective to use additional and updated information. Similarly, we agree with the CMA that the legal framework does not allow the CMA to disregard relevant, available and robust data. We believe that Ofwat's

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<sup>14</sup> That is, the LASSO can be useful in creating 'approximate sparsity' by removing features that do not meaningfully contribute to the model, leaving only those with appreciable contribution.

<sup>15</sup> To this end, a Group LASSO technique, which is in principle more suitable for dealing with variable selection where there are types and measures of variables, is also not appropriate.

concern is misplaced here; the ability to adduce new information is not a one-way bet for redetermining companies, given that Ofwat can equally raise issues for CMA consideration if updated data shows that its original approach in the final determination was unduly generous.

- (30) The CMA notes that it will consider whether to use outturn company performance data for the year 2024-25 in its final report. Thames Water supports the use of actual performance data in the final report and considers that a framework could be developed by the CMA in the provisional determination due in mid-September to allow for the use of robust and cleaned data in the final report.

#### **4 Conclusion**

- (31) To conclude, while Thames Water is aware of the need for the CMA to adopt a proportionate approach to its redetermination in line with the overriding objective, it is important that the CMA's approach does not unduly limit or restrict the scope or function of the redetermination framework set out in the Licence.
- (32) In particular, we ask that the CMA reconsider:
- (i) The application of a blanket de minimis threshold of 0.5%, as has been proposed. This is significantly higher than the 0.1% materiality threshold that has been applied in an "appeals" context and does not (as drafted) contain sufficient flexibility to accommodate the nuances of the regulatory framework.
  - (ii) The deprioritisation of issues that Ofwat has argued will be addressed through an alternative route. Thames Water is concerned that this approach creates inherent uncertainty and may also limit a company's legal recourse.
  - (iii) The deprioritisation of issues to reflect prior regulatory practice. In accordance with the underlying intent of the redetermination framework and the statutory duties, the CMA should consider whether prior regulatory practice is appropriate and delivers an outcome which is correct on its own merits in each circumstance.
  - (iv) The proposal to use a data-driven approach to variable selection using econometric tools for base cost modelling. Thames Water does not consider that the LASSO technique is suitable in this context and believes that human judgment is required in order to consider the nuanced arguments raised by the disputing companies concerning specific measures of cost drivers.
- (33) We would be happy to discuss the issues set out in this submission with the CMA, should this be of assistance at this stage of the CMA's process for the disputing companies.