

WATER PR24 REFERENCES

Provisional Determinations – Summary

09 October 2025

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Introduction

1. Every five years the sector regulator – Ofwat – decides how much revenue each of the 16 regional regulated water companies is allowed for providing and improving water and sewerage services in their area. This is called a price control.
2. In England and Wales, water and wastewater services are provided by privately-owned regional monopolies. As a result, there is no competitive rivalry to drive down prices or increase service quality, and incentives to innovate or be more efficient are limited. Economic regulation exists to compensate for this absence of competition.
3. The price control determines the amount companies can recover from customer bills. This is based on the money Ofwat decides companies need to spend on supplying customers, investing in improving services, and to achieve important obligations such as reducing pollution, as well as an allowed return to investors. The price control includes mechanisms that are meant to incentivise good performance and penalise poor performance. The price control aims to protect the interests of current and future customers.
4. In December 2024, Ofwat published its price control decisions (known as PR24) for each of the 16 regulated companies for the period 2025 to 2030 (with the time period referred to as asset management period 8 or AMP8). Any company that disagrees with its price control decision from Ofwat – for example, because it considers it has been allowed insufficient revenue to meet its obligations – can ask the Competition and Markets Authority (CMA) to review and ‘redetermine’ it.
5. Five of the 16 companies – Anglian Water (Anglian), Northumbrian Water (Northumbrian), South East Water (South East), Southern Water (Southern) and Wessex Water (Wessex) (together the Disputing Companies) rejected Ofwat’s price control decisions. The Disputing Companies serve over 7 million household and business customers and have a combined annual revenue of around £4 billion. On 18 March 2025, Ofwat referred the price controls of these companies to the CMA.
6. In February 2025, Thames Water also rejected its price control and has since been in discussion with Ofwat and others about its position. Thames Water and Ofwat agreed that Ofwat would defer making the reference to the CMA, to allow time for these discussions. In July 2025, Ofwat agreed to Thames Water’s request to again defer making the reference to the CMA for a further period until 22 October 2025.¹

¹ Thames Water (2025) [Thames Water CMA Reference Deferral Update - Friday 18 July 2025 14:44](#).

7. The other ten regulated water companies accepted Ofwat's PR24 price control decisions in full.
8. The CMA has to undertake these redeterminations by law. The organisation appoints an independent panel of expert decision makers to take these decisions (the Group). The full report published alongside this summary contains the Group's provisional redeterminations of the price controls of the five Disputing Companies.
9. We invite comments, which should be sent to waterpr24references@cma.gov.uk, no later than 5:30pm (UK time) on 6 November 2025. After considering all responses, we will make our final decisions by 17 March 2026.

Wider context

10. These redeterminations are taking place during a period of extensive debate and potential change for the water sector and how it is regulated.
11. Ageing infrastructure, climate change, population growth, and environmental concerns all pose increasingly serious risks to the reliability, quality, and sustainability of water supply and wastewater treatment in the UK. The water sector faces significant challenges in managing and mitigating these impacts to ensure the needs of people, businesses, and the environment are met. Investment is needed to meet these challenges and support economic growth, placing pressure on affordability for customers.
12. There has also been mounting concern about the financial resilience of some water companies, as well as the extent to which the management and financial structures of some companies may be properly serving the interests of current and future customers.
13. This has led to several reviews of the water sector, most recently by the Independent Water Commission (IWC).² Its final report, published in July 2025, concluded that a fundamental 'reset' of the water sector is needed to restore public confidence in the sector and its regulation, to attract the investment needed to clean up the waterways of England and Wales, and to establish a framework that will meet the water demands of the future.
14. During its nine-month review, the IWC heard evidence about a very wide range of issues – from infrastructure development to the oversight of company finances. Its 88 recommendations cover areas as diverse as: the strategic direction for the

² IWC (2025) [Final Report](#). See also, for example: National Audit Office (2025) [Regulating for investment and outcomes in the water sector report](#); Environment Agency (2025) [New report finds systemic water company failure and underperformance](#) (accessed 2 September 2025); and House of Lords Industry and Regulators Committee (2023) [The affluent and the effluent: cleaning up failures in water and sewage regulation](#).

water system; planning; the legislative framework; regulator and regulation reform; company structures, ownership, governance and management; and infrastructure and asset health.

15. In its initial response to the IWC's report, the UK government said that 'Our water industry is broken' and announced what it calls 'the biggest overhaul of water regulation in a generation'.³ The government intends to abolish Ofwat and create a new single regulator, bringing together economic regulation and the water functions of the Environment Agency, Natural England and the Drinking Water Inspectorate. The full government response to the IWC's recommendations is expected in a White Paper later this year and it intends to introduce a water reform bill early in this parliament.
16. The scope of the IWC's work was much wider than the price control matters on which we must decide for the five Disputing Companies. That said, many of the issues in the report were also raised with us, including the need for increased investment and for a regulatory framework that ensures companies deliver effectively for customers and protect the environment.

The scope of our role

17. We must redetermine the price control decisions for the five Disputing Companies before 17 March 2026.
18. Fundamental decisions about the structure of the water sector and how it is regulated, including whether and how to implement the IWC's recommendations, are necessarily for government. The IWC's terms of reference were clear that its recommendations would be for future economic regulation, not for PR24 and the current price control period. While the Group is aware of the context in which our redeterminations take place, we are required by law to take our decisions within the confines of the existing regulatory framework. Some of our provisional decisions nonetheless align with the IWC's recommendations.
19. We are required to make these decisions in accordance with the principles that apply to Ofwat, including its various statutory duties and in light of the UK government's [Strategic Priority Statement](#) for Ofwat. However, we are not bound to follow the same approach as Ofwat. We must also consider whether new information is available that we should take into account.
20. The redeterminations are highly complex, and it is not feasible or appropriate in one year to replicate all the work done by Ofwat in its price controls over four

³ Defra (2025) [Ofwat to be abolished in biggest overhaul of water since privatisation](#); and UK Parliament (2025) [Independent Water Commission - Hansard](#).

years. Our decisions also apply to only a minority – 5 of the 16 – regulated water companies.

21. Within that context, we have sought to carry out the redeterminations fairly, efficiently and at proportionate cost within the statutory timeframes.⁴ We set out our proposed approach (including what we were prioritising and deprioritising) in our [Approach document](#) published 28 May 2025.

Ofwat's PR24 price control decisions for the water sector

22. Ofwat used three basic 'building blocks' for developing the PR24 price control: (i) assessments of the companies' costs to determine their **expenditure allowances**; (ii) an **Outcomes framework** to incentivise delivery and performance and penalise non-delivery and underperformance; and (iii) an assessment of what **balance of risk and return** should attract the investment required. Together these building blocks form 'the package' of the overall price control.

Expenditure allowances

23. In its PR24 Final Determinations (PR24 FD), Ofwat increased expenditure allowances to £104 billion (compared to £62 billion in the previous price control, PR19),⁵ including allowing around four times the amount of expenditure on improvement projects than in the PR19. Ofwat's view was that a step change in investment was required, largely to meet new legal requirements (for example, in water resource management plans and the environmental programmes of the Environment Agency and the Drinking Water Inspectorate).⁶

Outcomes framework

24. Alongside the increased funding provided to the companies in the PR24 FD, Ofwat made significant changes to its framework of performance targets, incentives, penalties and clawback mechanisms (known as the 'Outcomes framework'). Under the Outcomes framework, companies return money to customers if they do not provide defined deliverables or achieve performance targets but can earn more money if they outperform.
25. Ofwat's PR24 FD increased the specificity of required outputs, made greater use of common (rather than bespoke) performance commitments for areas important to all customers, and imposed stronger incentives and penalties to drive improvements in performance. It made these changes to help ensure that money

⁴ This objective is described as the CMA's 'overriding objective' in [Competition and Markets Authority Water Reference Rules \(CMA204\)](#), December 2024 (Rules), Rule 4.1. The Rules set a framework for how we conduct water references.

⁵ Both amounts in 2022/2023 prices. The previous price control period was 2020–2025.

⁶ Ofwat (2025) [PR24 final determinations: sector summary - republished 12 May 2025](#), pp3–5 and 9. Ofwat (2025) [PR24 final determinations: Expenditure allowances](#), p3; Ofwat (2025) [PR24 final determinations: Our approach](#), pp29–30; and Ofwat (2025) [PR24 final determinations – City briefing](#), p7.

from the increased customer bills is used to deliver the right outcomes for customers and that customers do not pay for the same thing twice, because allowances in previous years have not been spent appropriately.

Balance of risk and return

26. Companies require money upfront to fund investment, which is provided by debt and equity investors. Investors expect to earn a return which reflects the risk of their investment – otherwise they may invest their money elsewhere. Ofwat's PR24 FD provides for this return through an 'allowed rate of return'. This is not guaranteed and the actual return that companies receive depends on their performance.
27. Ofwat's PR24 FD included an allowed rate of return of 4.03%. Ofwat also considered the appropriate 'balance of risk and reward', ie how much potential for variation in investor returns is reasonable, given the risks the investors are taking. This included introducing specific mechanisms to limit the overall scope for returns to deviate from the allowed level.
28. The decisions Ofwat made on three elements described above – expenditure allowances, the Outcomes framework and the management of the risk and return to investors – determined the PR24 price control. Ofwat's PR24 FD would have resulted in average increases in annual bills for customers of water and wastewater companies of £31 per year (before inflation) between 2024/25 and 2029/30.⁷

Reasons for Disputing Companies rejecting Ofwat's price control decisions

29. The Disputing Companies asked for further increases in revenue of £2.7 billion in total on top of the £26.6 billion allowed to them by Ofwat. While Anglian, Northumbrian, South East, Southern and Wessex each provided extensive and different reasons for rejecting Ofwat's price control decisions, there were some common themes in their arguments that:
 - (a) Ofwat had provided insufficient funding for maintaining and replacing the water companies' pipes and other assets;
 - (b) Ofwat had made mistakes in what it expected allowances for day-to-day expenditure to fund;
 - (c) Ofwat had set the cost of capital (the returns to investors) too low; and

⁷ Ofwat [What the 2024 price review means for water customers](#) (accessed on 4 September 2025).

(d) Ofwat had failed to appropriately balance the risk and return for investors, including in its Outcomes framework, so that the water companies would not be able to raise finance for their activities.

30. We are mindful of Disputing Companies' incentives to selectively raise areas where Ofwat's price control decisions might be unfavourable to them but also note that a redetermination process can result in allowances being lowered for some companies (including because changes in methodology can impact different companies in different ways).

Considerations in making our provisional decisions

31. We carefully reviewed extensive evidence from the Disputing Companies, Ofwat and over 40 third parties including the Consumer Council for Water, representatives of investors, environmental groups, consumer groups, business customers, and other water companies which have accepted Ofwat's PR24 price control decisions.
32. We assessed the Disputing Companies' requests for additional funding in detail. We scrutinised the evidence to decide if the spending proposed is necessary to deliver the right outcomes for customers, and whether the amount requested represented efficient costs (so customers do not pay for inefficiency or more than is needed).
33. We sought to ensure that customers genuinely benefit from the bill increases they are bearing and are not funding improvements for which they have already paid. We carefully considered the interests of customers in our approach – both in terms of the levels of bills and affordability and also in relation to critical outcomes (like a reliable water supply and reduced leakage), now and in the future.
34. We sought to ensure that companies have enough funding for what they are expected – often legally mandated – to achieve. We also sought to ensure that returns to investors reflect the risk in the PR24 price control as a whole, so that companies are able to raise the substantial finance required for investment at a time of challenges and instability in the water sector.
35. We have reached our provisional redeterminations in accordance with the statutory principles that apply to Ofwat, including various statutory duties. Our provisional decisions reflect our judgement on how these principles should be interpreted and balanced. We have also considered the provisional overall price control in the round for each Disputing Company and provisionally decided that each is consistent with the relevant statutory principles.

Overview of our provisional decisions

36. The building blocks of Ofwat's price control are described in paragraphs 22 to 28 above. We used these same building blocks in our redeterminations, with provisional decisions on each set out in our provisional redeterminations report (CMA PD) published on our [case page](#).
37. For the reasons set out in detail in the full report, we provisionally rejected nearly 80% of what the Disputing Companies asked for by way of increased revenue. Our provisional redeterminations allow a total increase of £556 million in revenue for the Disputing Companies (21% of what they collectively sought).

Expenditure allowances

38. In our redeterminations, we made changes to Ofwat's economic modelling of routine expenditure with the intention that allowances better reflect differences in operating environments between companies. At the same time, we applied a stretching efficiency challenge to help ensure that customers served by inefficient companies (who have no option to switch to a different supplier) do not pay for poor operational performance. Our revised approach to day to day expenditure results in higher allowances for three companies and lower allowances for two companies.
39. The Disputing Companies also made requests for funding to enhance their networks or services. We agreed with these only where there was sufficient evidence of both the need for and cost efficiency of the additional funding requested. On this basis, we have largely rejected the Disputing Companies' requests for funding for new activities and projects beyond the significant increases already allowed by Ofwat. Where we have allowed additional funding for new activities or projects, it is to deliver on issues that matter to customers, like addressing water supply interruptions, pollution or leakage.
40. In addition, we agree with the IWC that further work is urgently needed to assess the condition of water infrastructure and ensure that companies maintain and improve it going forward.

Outcomes framework

41. We made some limited adjustments to performance targets and incentive rates within Ofwat's Outcomes framework. While we acknowledge that calls have been made for more fundamental reforms to the framework (including by the IWC), it would not be appropriate or achievable to seek to address these through the redetermination process given its limited time and scope.

Balance of risk and return

42. The rate of return for investors is a key decision when it comes to ensuring companies can access the finance they need to deliver the outcomes for current and future customers. We have provided for a slightly higher rate of return than allowed by Ofwat, including a higher cost of equity and a lower cost of debt. More than half of this change results from external market movements (primarily the increases in interest rates) since Ofwat's decision in December 2024 (which we are bound to take into account) with the rest stemming from targeted methodological changes.

Overall impact

43. The impact of our provisional decisions on Disputing Companies' revenue is set out in more detail in Table 1 below.
44. The Ofwat PR24 FD would be expected to result in an increase in bills of 24% on average for the Disputing Companies compared with bills in 2024/25. Our provisional redeterminations would result in increases in average annual bills of 3% on top of Ofwat's PR24 FD for the Disputing Companies. An indication of what this would mean for average customer bills is laid out in Table 2 below.

Table 1: Impact of our provisional redeterminations on total revenue

Disputing Company	Ofwat's PR24 FD AMP8 allowed revenue	Disputing company statement of case AMP8 allowed revenue			CMA provisional redeterminations AMP8 allowed revenue		
		AMP8 allowed revenue	£ million change from Ofwat's PR24 FD AMP8 allowed revenue	Percentage change from Ofwat's PR24 FD AMP8 allowed revenue	AMP8 allowed revenue	£ million change from Ofwat's PR24 FD AMP8 allowed revenue	Percentage change from Ofwat's PR24 FD AMP8 allowed revenue
Anglian	£9,634	£10,552	£918	9.5%	£9,751	£117	1.2%
Northumbrian	£5,205	£5,495	£290	5.6%	£5,257	£52	1.0%
South East*	£1,679	£1,960	£282	16.8%	£1,751	£72	4.3%
Southern	£6,466	£7,416	£949	14.7%	£6,645	£179	2.8%
Wessex	£3,632	£3,875	£243	6.7%	£3,768	£137	3.8%

Source: CMA analysis; 'Ofwat's PR24 FD AMP8 allowed revenue' from Ofwat (2024) [PR24 Key Dataset 2 Costs Past Delivery and Risk and Return data](#), 'Allowed Revenue' sheet (in 2022/23 CPIH real prices); and 'Disputing company statement of case [...] Percentage change from Ofwat's PR24 FD AMP8 allowed revenue' from Disputing Companies responses to Disputing Companies RF108.

Note: £ million, 2022/23 CPIH real prices.

* South East is a water only company (WoC); each of the other four Disputing Companies is a water and sewerage company (WaSC).

Table 2: Indicative impact of our provisional redeterminations on annual customer bills

Disputing Company	Company average bill	Ofwat's PR24 FD		Disputing Company statement of case average bill for AMP8		CMA provisional redeterminations Disputing Company AMP8 average bill	
	2024/25 (final year of AMP7)	Company average bill for AMP8	Percentage change from final year of AMP7	Company average bill for AMP8	Percentage change from Ofwat's PR24 FD AMP8 average bill	Company average bill for AMP8	Percentage change from Ofwat's PR24 FD AMP8 average bill
Anglian	£491	£591	20.4%	£649	9.8%	£599	1.3%
Northumbrian	£422	£488	15.6%	£515	5.5%	£495	1.3%
South East*	£232	£274	18.1%	£322	17.5%	£286	4.4%
Southern	£420	£620	47.6%	£710	14.5%	£638	2.8%
Wessex	£508	£594	16.9%	£642	8.0%	£622	4.7%

Source: CMA analysis (for 'CMA provisional redeterminations Disputing Company AMP8 average bill'); Ofwat's PR24 FD financial models for 'Ofwat's PR24 FD'; and Disputing Companies responses to Disputing Companies RF107 (for all other columns), which requested £ figures in 2022/23 CPIH real prices as per Disputing Companies' statements of case.

Note: these are indicative forecasts of average bills. Actual bills will vary according to, for example, average customer water consumption and company performance. AMP7 is asset management period 7, a five-year regulatory period used by Ofwat to set price controls for water companies, from 2020 to 2025.

*South East is a WoC; each of the other four Disputing Companies is a WaSC. Bills for South East therefore do not include the cost of wastewater services as it is a water-only company.

45. We understand that household budgets are under pressure and that our provisional decisions would result in a further increase in customer bills. However, our detailed analysis indicates that some additional allowances are needed. These should allow the Disputing Companies to attract investment and deliver the improvements in standards and performance that current and future customers need, as well as to meet their legal obligations, including those within water resource management plans and imposed by the regulators for drinking water quality and environmental matters.
46. Alongside these revised allowances, we have maintained clear penalties and incentives which are intended, within the confines of the existing regulatory system, to drive companies to deliver on time and to budget.
47. The sections below provide more detail on what we have provisionally decided for each building block of the price control redeterminations.

Content of our provisional redeterminations

Expenditure allowances

48. We looked at the amount of money that the Disputing Companies had been allowed by Ofwat for total expenditure. This consists of base costs and enhancement costs. **Base costs** are routine, year-on-year costs, which companies incur in the normal running of the business to provide a base level of

service to customers and to maintain assets, such as water treatment works and water mains. **Enhancement costs** relate to expenditure required to achieve a step change in service levels, which could be to meet new requirements or allow for growth in demand for water.

49. Ofwat uses a series of complex models to assess **base cost allowances** with some adjustments where the particular circumstances of a company are not considered to be properly reflected in the modelled costs.
50. Using a mechanism known as 'catch-up efficiency', Ofwat calculated the allowances for all companies based on the expenditure of comparatively efficient companies. Ofwat also imposed a **frontier shift** on all companies. The frontier shift reflects the rate of efficiency improvements, across all expenditure allowances, that even the most efficient companies in the industry could be expected to achieve – and would be expected to do so in a competitive industry.
51. The Disputing Companies raised several detailed issues about Ofwat's models. They argued that the outputs of Ofwat's base cost models did not accurately represent the costs they would incur to provide services and maintain their asset base. They argued that Ofwat was expecting unrealistically high efficiency improvements. The Disputing Companies also asked for additional allowances where they argued that their specific circumstances justified them.
52. We have provisionally decided to use a different modelling approach to assess these requests under a single framework. Our approach results in simpler models that explain a larger share of cost differences between companies. As such, we consider that it provides a more robust way to set base cost allowances in these determinations. The resulting models incorporate most of the cost drivers used by Ofwat and some, though not all, of the cost drivers put forward by Disputing Companies.
53. Our modelling approach results in a higher catch-up efficiency challenge than Ofwat's. We think this is appropriate, as the efficiency challenge is an important way of protecting the interests of customers, who have no choice but to be served by their local company – however inefficient. Our models have better explanatory power and therefore are more likely to identify inefficiency.
54. We have also provisionally decided to lower the frontier shift and adjust some performance targets. Taken in the round with the catch-up efficiency challenge in our modelling, we consider that the overall efficiency challenge faced by companies is reasonable.
55. We also assessed a number of cost adjustment claims where the Disputing Companies claimed for costs that they considered were not reflected in the base cost allowance modelling. We have provisionally made some adjustments to base

models explicitly to capture three of the cost drivers underpinning these claims: differences in regional wages; economies of scale at water treatment works; and energy costs. We also changed the assessment of 'what base buys', which affects the allowance granted to companies to improve asset health. We have provisionally rejected all other cost adjustment claims, as we considered that the Disputing Companies provided insufficient evidence that such adjustments were needed or that the estimated costs were efficient.

56. Ofwat also used models to partly determine **enhancement cost allowances**. These models compared costs of similar schemes across the regulated companies to estimate the costs that a comparatively efficient company would be expected to incur for a particular type of project. If a proposed enhancement investment did not lend itself to this type of benchmarking, Ofwat carried out more detailed investigations of the relevant scheme. In deciding what costs to allow, Ofwat took into account what it expected to be incurred by an efficient company.
57. The Disputing Companies argued that the outputs of Ofwat's modelling did not give a realistic estimate of funding required for their specific circumstances. We received 30 requests from Disputing Companies to increase allowances for planned enhancement schemes and projects which Ofwat had said in its PR24 FD were either unnecessary, already funded within base cost allowances expenditure or the previous price control, or for which estimated costs were too high and inefficient.
58. As with base costs, we have improved the modelling of certain enhancement scheme costs. This has changed some modelled allowances, for example for phosphorus removal schemes. We also looked in more detail at the plans and projected costs of several schemes where higher allowances were requested. For most of these schemes we provisionally decided that there is insufficient evidence that more funding was appropriate. In some cases, we have provisionally provided more funding, but applied an 'efficiency challenge', reducing cost allowances by 10 to 30% from what had been requested. We did this where we were not satisfied that the requested costs represented costs that would be incurred by an efficient company ('efficient costs').
59. Where we have provisionally allowed more funding for enhancements, it is to deliver on issues that matter to customers. Examples include funding to reduce leakage, prevent water supply interruptions that can leave customers without water (sometimes for prolonged periods), to address pollution, or for phosphorus removal from wastewater to prevent environmental harm and safeguard aquatic ecosystems.
60. For some enhancement schemes, we have provisionally decided that the amount of money that would be needed is too uncertain at this point to provide a specific cost allowance. Instead, we provisionally decided that companies should use

existing Ofwat mechanisms (such as the 'large scheme gated process') where companies can apply for funding as costs become clearer. This reduces the enhancement cost allowance at this point but, if the scheme progresses, revised allowances can be claimed later.

61. We provisionally decided that it is appropriate to apply a frontier shift to expenditure allowances. Our analysis indicates that productivity improvements for water companies have been in line with the wider economy over the recent period and have been close to zero. Therefore, we assessed official forecasts of productivity change in the wider economy to inform our decision on the frontier shift. Reviewing these forecasts and other evidence in the round, our provisional decision is to set the frontier shift at 0.7% (which is higher than the average frontier shift requested by the Disputing Companies of 0.62%).
62. Taken together, our changes to expenditure allowances result in lower allowances for two Disputing Companies (Anglian and Northumbrian), and higher allowances for the others (South East, Southern and Wessex).

The Outcomes framework (penalties and incentives)

63. The Disputing Companies argued that some target performance levels in Ofwat's PR24 FD were too stretching and unrealistic, and that what they regarded as inevitable and severe penalties would reduce their ability to make required improvements in performance. Overall, they argued that companies were subject to unacceptable downside risks, given the impact that likely penalties would have on returns to investors.
64. It is critical that companies have sufficient incentives to deliver the projects and outcomes for which they have been funded, and that they are held to account when they do not. We note the IWC's criticisms of the framework seeking to achieve this. However, as set out in paragraph 20 above, it is not feasible or appropriate for the Group to make fundamental changes to the regulatory framework within the confines of our narrow role. More fundamental changes to the regulatory framework are for government and best addressed through industry-wide policy setting.
65. Acknowledging our limited role with regards to the Outcomes framework, we have made some adjustments to Ofwat's decisions in some areas, either because we consider that Ofwat did not use appropriate data or that the way the penalties were calculated would disincentivise efforts to improve performance.
66. Our analysis indicates that the overall impact of our provisional decisions is to slightly lower the risk of underperformance for the Disputing Companies in some areas. However, we retain important drivers to improve performance and (where necessary) penalise poor performance in areas that are critical to current and

future customers. This includes storm overflows (which lead to pollution), external sewer flooding and water supply interruptions.

67. We also looked at the penalties for companies that fail to deliver agreed investments on time – penalties the companies said introduced excessive risk. We do not share that view. We consider these penalties important to help ensure (as far as possible within the current regime) that companies deliver the new infrastructure that customers pay for. We also took into account that Ofwat is expected to issue new guidance which should improve clarity for the companies on how such penalties may be applied.

Balance of risk and return

68. A key concern of the Disputing Companies was the allowed rate of return in Ofwat's FD. In particular, they do not consider the balance of risk and return sufficiently attractive to encourage the amount of investment widely acknowledged to be required in the water sector during the next five years.
69. In deciding on the appropriate methodology and in reviewing the various pieces of evidence put to us, we kept in mind the following principles in our provisional decisions on the allowed rate of return.
- (a) **Maintaining consistency:** Consistency and predictability over time of regulatory cost of capital decisions are likely to have a positive impact on the overall attractiveness of UK water infrastructure to investors. This, in turn, is expected to benefit customers by lowering the costs of financing investment needed to deliver services and improvements.
 - (b) **Reducing regulatory complexity:** While the cost of capital methodology should be theoretically robust, it also needs to be transparent and practicable to implement.
 - (c) **Recognising uncertainty:** There is significant uncertainty around the expected cost of capital. It is important to consider the evidence in the round, and it is generally desirable to limit the number of more subjective adjustments to the underlying market data.
70. We used the Capital Asset Pricing Model (CAPM) to estimate the allowed return to equity investors, and we considered each of the parameters of the CAPM in turn, using updated market data in our calculations.
71. A combination of market movements (primarily the increases in interest rates) since Ofwat set the allowed return, together with some targeted methodology changes, has meant that our provisional decision has led to a higher allowed return on equity compared with Ofwat. The increase has been partially offset by a

reduction in the real allowed cost of debt, where we have taken into account changes in expected inflation.

72. Overall, the allowed return has increased from 4.03% to 4.29% (with over half of the increase due to market movements).
73. As well as looking at individual elements of the price control, we considered the balance of risk and return in the overall price control for each Disputing Company.
74. The Disputing Companies submitted analysis suggesting that Ofwat's PR24 FD as a whole would be likely to result in a significantly lower equity return than the specified allowed return – particularly given the downside risks of underperformance and subsequent penalties.
75. We have reviewed this analysis and consider that the assumptions are not consistent with the purpose of modelling the risk faced by an efficient company. We therefore do not place any weight on it. Overall, we consider that our provisional redeterminations result in balanced price controls or a 'fair bet', in the sense that the risks for an efficient company of earning more or less than the specified allowed return are broadly similar.
76. The Disputing Companies also asked us to review two mechanisms introduced by Ofwat in its PR24 FD to manage the extent of downside and upside variation of equity returns for investors – the Aggregate Sharing Mechanism (ASM) and the Outturn Adjustment Mechanism (OAM). We have provisionally concluded that, taken together, the ASM and OAM provide a sufficient level of downside risk protection and therefore both should be retained in the current form.