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Citizens Advice response to the water PR24 provisional redeterminations

For the attention of the CMA Panel

Summary of submission

Introduction

1. Citizens Advice has statutory responsibilities for representing energy, heat networks and post consumers in Great Britain, and we also advocate and provide advice for consumers on cross-cutting issues.

2. We are responding to the water PR24 redeterminations for two reasons: firstly because of the importance of water to consumers, and secondly because the CMA's decision on these appeals will set an important precedent for other sectors (such as energy).

3. We have focused particularly on areas where there is a risk of a precedent being set that would be detrimental to consumers. We believe that compelling evidence should be required in those circumstances, especially where the approach being proposed is a break from current regulatory practice. Maintaining regulatory predictability and stability is vital for long-term interests of both consumers and companies.

4. We would like to highlight:

a. The inclusion of more up to date data is not required by the guidance for redeterminations and creates a further structural advantage for the regulated companies.
b. The use of a 3 year sampling period for equity beta needs to be justified on its own merits, rather than as being required to include a further comparator.
c. There is not sufficient evidence to justify the inclusion of introducing 'stable ERP' methodologies to inform the TMR range. This is a departure from existing regulatory practice and UKRN guidance.

5. We ask that CMA reconsiders the issues we have raised in this response and also makes more, and better, use of real-world evidence and cross-checks:
    a. The approach to Market Asset Ratio (MAR) cross-checks appears to be flawed and should be revised. An expectation of outperformance should not be included in MAR calculations. Expectation of outperformance is a potential *explanation* for premia, it should not be used for calculating premia.
    b. 'Raw' equity betas should be used to assess whether Pennon's high notional equity beta reflects underlying business risk or is primarily related to the methodology employed.
    c. The point estimate for the cost of equity should not be chosen on the basis of a hypothetical risk of under-investment, rather evidence should be provided that this risk is material.
    d. The debt-to-equity premium should not now be introduced as a cross-check, since fluctuations in the debt-to-equity premium are a natural consequence of the historically agreed stable TMR approach.

6. We have not sought to identify all issues that the CMA should reconsider. This should not be taken as a view that these do not exist.

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Volume 1: background chapters and base costs

Use of new evidence and updated information

7. We do not agree that the CMA is required to reach a decision about the correct price control to be applied at the time the redetermination is made. Allowing the use of new data during the appeal process gives companies a structural advantage. Companies face a strong incentive to appeal if the data moves in their favour at any point in the two month appeal window.

8. The CMA acknowledges that:

   "taking account of more recent data than was available to Ofwat risks creating incentives on companies to challenge Ofwat's determination where they consider the new data is likely to result in a better outcome for their businesses."[1]

9. Although recognising this risk, the CMA justifies its use of new data on the basis that:

   "our role in providing a redetermination means we are not simply deciding whether Ofwat's PR24 FD was right or wrong, but rather we are required to reach a decision about the correct price control to be applied at the time we make the redetermination. In this context, we consider that the current regulatory framework would not allow us to take a blanket decision to disregard evidence that was unavailable to Ofwat. Instead, we have considered whether new data that becomes available to us is relevant and robust, and able to be properly analysed and quality assured within the timescale of our redetermination process."[2]

10. It is our view that the legal framework underpinning the regulatory regime gives the CMA discretion in how it conducts its redetermination, including the time period of data used, provided that it acts in accordance with the principles which, by virtue of Part I of the Water Industry Act 1991, apply to determinations made by Ofwat (section 12(3)(b) of the Water Industry Act 1991).[3]

11. Further, neither the CMA's Water References Rules nor the Guide prescribe that the correct price control must be determined with reference to the point in time at which the CMA makes its redetermination. They do not prohibit the CMA from applying its assessment to the point in time when Ofwat made its final determination.

[1] WATER PR24 REFERENCES Provisional Determi nations Volume 1. CMA. 2025. p.38 .
[2] Ibid. p.38
[3] Water Industry Act 1991.

12. The Guide states only that:

    “the CMA is required to undertake a full redetermination of the Authority’s determination.”[4]

13. The Guide further states that:

    “The CMA is able to take account of current circumstances and information which is now available, which may not have been available at the time of the disputed determinations, and the CMA can also seek further evidence. Where there is relevant additional and updated information available, produced since the disputed determination (including information, views and evidence produced and provided to the CMA by the main parties during the course of the redetermination reference), the CMA can take appropriate account of this to inform its determination(s).”[5]

14. However, this wording permits the use of new data but does not mandate it. The ability to take account of new or updated information does not equate to an obligation to do so. We believe the guidance is clear that including new data is a choice. In light of this, the CMA should now consider this choice and act with caution as allowing new data would distort incentives within the statutory appeal framework.

15. It is our view that within the current regulatory framework, the CMA is open to determine that the appropriate basis for a redetermination is the evidence and circumstances available at the point Ofwat made its Final Determination. This would avoid introducing further asymmetry into an already asymmetric appeals regime. Only companies may refer a decision to the CMA; consumers have no equivalent right. Using new data, available only after Ofwat’s determination, compounds this imbalance by enabling companies to benefit from favourable timing and by increasing the likelihood of appeals motivated by opportunistic data changes rather than genuine regulatory error.

16. Applying the redetermination at the time of Ofwat’s Final Determination would reduce incentives for strategic appeals, avoid exacerbating existing asymmetries between companies and consumers, and better preserve the integrity and predictability of the price control process.

[4] Water References: Competition and Markets Authority Guide. CMA. 2024. P.11.
[5] Ibid. p.12

Volume 4: Allowed return, risk and return and closing chapters

Allowed return on equity

Beta

Beta sampling period

17. The CMA estimates 10 year betas for Severn Trent and United Utilities to inform the bottom range of its unlevered beta range, and estimates 3 year betas for Severn Trent, United Utilities and Pennon to inform the top end. Citizens Advice do not think that the use of a 3 year sampling period has been justified in the CMA's provisional determination. The 3 year period has been used to allow Pennon to be included in the sample, not because it has been deemed that a 3 year sample period is optimal, as acknowledged by the CMA:

    "if we were to give weight to Pennon in our beta range, we would need to rely on relatively short estimation windows"[6]

18. Citizens Advice have previously outlined evidence that short-term betas suffer from upward bias. [7] This is because short-term movement in equity and bond prices is strongly correlated with overall market indices, such as the FTSE All Share Index. The covariance of index-constituent equity and bond prices (and returns) with market indices is independent of the underlying systematic risk applicable to individual index constituents. In comparison, it is typically only when individual equities or bonds enter or exit an index that there is a greater divergence in prices and associated returns from the index. This equity and bond market trading behaviour therefore results in a strong bias of short-term beta estimates towards "1" for all firms in a given index compared to the underlying long-term systematic risk and beta.

19. This is recognised by academics. For instance:

    "[One] driver of co-movement of returns is commonality in trading activity [...] simply by virtue of being part of the stock index [...] exhibit excessive covariation in their returns [...especially] in the short run [...whereas] at long horizons,

[6] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. p.78.
[7] Ofgem consultation on RIIO-2 Draft Determinations Finance Annex. Citizens Advice. 2020.

returns [...] revert to reflect fundamentals."[8]

20. The UKRN 2018 cost of capital report includes an appendix by Stephen Wright and Donald Robertson on estimation of beta at longer horizons. They argue that:

    "if [UK utility regulators] are concerned to assess the nature of systematic risk at long horizons, [they] should ensure that our estimation techniques are consistent with that horizon [whereas, in contrast...] what is now standard practice in beta estimation: the use of relatively short (2- 5 year) samples of, usually daily data [...] reflects the relatively short-term objectives of most users of estimated betas in the finance industry". [9]

21. Accordingly, the report recommends a "fairly long horizon, for example, 10 years"[10] on grounds that this is "more relevant to the long horizons used by regulators"[11]

22. Whilst we acknowledge the CMA's position that there are pros and cons to different beta sampling period lengths, inconsistent approaches across price controls undermines stability in the regulatory framework. We note that at PR19 Ofwat's draft determination position utilised two year betas. In response to the two year betas being seen as too low, water companies submitted evidence in favour of longer term betas. Subsequently Ofwat and the CMA additionally estimated 5 and 10 year betas, raising the notional equity beta. By contrast at PR24, Ofwat opted for 5 and 10 year betas, noting that shorter-term betas are volatile and were liable to be misleading estimates of future beta. Some water companies included evidence in favour of shorter term betas and the CMA has also introduced the lower 3 year betas into the range. The switch in positions, typically leading to an increase in notional equity beta each time, weakens credibility in the regulatory framework and risks creating the perception that the process is responsive to company preferences rather than grounded in stable, evidence-based regulation.

23. It is our view that the CMA has not provided evidence that "the additional information value provided by using Pennon as a comparator outweighs any drawbacks of using shorter-term betas".[12] The upward bias from using shorter

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[8] Robin M. Greenwood and Nathan Sosner, "Trading Patterns and Excess Comovement of Stock Returns", Financial Analysts Journal, Sep. - Oct., 2007, Vol. 63, No. 5.
[9] UKRN report, Appendix G: Beta Estimation for CAPM-WACC at Long Horizons, by Donald Robertson and Stephen Wright (the "Robertson and Wright report"). 2018. P.139.
[10] Wright at al., UKRN report: Estimating the cost of capital for implementation of price controls by UK Regulators, 2018. P.7.
[11] Ibid, P.9.
[12] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. p.78.

term betas has not been quantified against any potential value from having an additional comparator. Three year betas should not be adopted to allow inclusion of a specific comparator, but should be measured against whether it is a methodologically justified sampling period. Particularly since there is precedent for using longer-term betas across the regulated sectors and this position should be maintained to provide stability and predictability.

24. For example, at PR19 redeterminations, the CMA “acknowledge the potential presence of ‘noise’ in short term estimates”[13] recommending the estimation should sit alongside longer periods and frequencies to provide the most robust data from which to estimate equity betas. At the 2021 energy appeals, the CMA did not find that GEMA was wrong in placing most weight on its 10-year estimate,[14] and did not receive “sufficiently strong evidence to indicate that a 10-year led approach leads to an inappropriate estimate of the appropriate beta.”.[15] In RIIO-3 draft determinations, Ofgem has proposed an asset beta range from the spread of comparator 10 year betas exclusively. Given there is precedent for sole or majority weight given to longer-term betas, we think careful consideration should be given to diverting from this approach.

Unlevered beta values

25. We note disagreement over the suitability of Pennon as a comparator on substantive grounds. The CMA acknowledges that “across all three estimation windows, Pennon’s beta is higher than the betas of Severn Trent and United Utilities.”.[16] Since the CMA only provides unlevered betas, we cannot ascertain whether Pennon’s raw equity betas sit above the other comparators, or whether Pennon’s high unlevered betas are the product of the de-gearing and re-gearing process.

26. When de-gearing and notional re-gearing are applied, these adjustments can mechanically inflate beta, even if raw equity betas are relatively low, because differences between actual and notional gearing are amplified in the unlevered beta calculation. If a company’s actual gearing is broadly similar to the notional level, the raw equity betas alone can be directly compared. If capital structure issues drove Pennon’s historical exclusion, it could have historically been included on the basis of raw equity betas, which do not require de-gearing or re-gearing and therefore avoid distortions arising from capital structure

[13] Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report. CMA. 2021. p.859.
[14] Final determination Volume 2A: Joined Grounds: Cost of equity. CMA. 2021.
[15] Final determination Volume 2A: Joined Grounds: Cost of equity. CMA. 2021. P.185.
[16] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. P.72.

differences. Since Pennon could always have been included on a raw equity beta basis, we question the timing of its inclusion now when it raises the equity beta range. Including a new comparator is a significant decision and introduces unpredictability into the regulatory framework. We request that the CMA provides historical raw equity betas for Pennon and the other comparators to assess Pennon's inclusion at this time.

27. As the diversity of views shows, estimating beta is challenging. It is the component of cost of equity that requires the greatest degree of judgement and discretion, and it is therefore important that the right approach is chosen to ensure consumers are not over-charged. If Pennon is to be considered as a comparator, we request the CMA to provide further evidence that quantifies the benefits of its inclusion outweigh the costs to consumers.

TMR

28. The upward bias within decisions that have been taken in estimating the equity beta sit against a backdrop of further proposals, elsewhere in the cost of equity determination, that act to provide a more generous package. For instance, the unprecedented decision to introduce 'stable ERP' methodologies to inform the TMR range. This is a departure from existing regulatory practice and UKRN guidance. Maintaining regulatory predictability and stability is vital for long-term interests of both consumers and companies. Therefore, compelling evidence is required to move away from established positions.

29. It is our view that the CMA has not provided sufficient evidence to support a methodological change. The CMA justifies the change due to a concern that the current approach to estimating TMR may lead to an under-estimate of the cost of equity. However, historically, consumers have funded an over-estimate, as acknowledged by the CMA:

    "the stable TMR approach adopted by regulators post the GFC has supported relatively high allowances for the cost of equity across the different regulated sectors."[17]

30. The CMA also recognises that "if investors have a relatively long-term investment horizon, a through the cycle approach to estimating the TMR should not systematically overreward or underreward investors in different interest rate cycles". [18]

[17] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. p.62.
[18] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. P.63.

31. Consumers have funded an over-estimate of the cost of equity during lower interest periods on the basis that the stable TMR approach would be maintained and this would be off-set during higher interest rate periods. It is not fair or robust to make a methodological change partway through the cycle. This fails to meet the principles of regulatory stability and predictability and so undermines confidence in the regulatory framework.

32. The increase in capital requirements under PR24 do not justify changing the methodology which has been in place across prior price controls in water and energy. Evidence would need to be provided on methodological grounds as to why a change was *required*, not simply preferred.

Cost of equity point estimate

33. The more generous decisions proposed for estimating beta and the TMR are in addition to setting the point estimate significantly higher than the CAPM mid-point and 2 bps points higher than Ofwat's proposal.

Market-to-asset ratios

34. Citizens Advice supports the use of cross-checks to inform the point estimate, including MAR analysis. However, we note that the MAR analysis has been undertaken with an outperformance assumption of 2% informing the upper end of the range. This assumption embeds outperformance. Since MARs are already driven by expectations of future regulatory returns, assuming additional outperformance introduces circularity into the model. The CMA infers a higher cost of equity from a model that itself embeds higher implied returns from the outperformance assumption. As a result, the CMA's MAR-derived estimate is no longer independent market evidence. On this basis it would make sense to disregard the high scenario of the MAR inferred cost of equity. Since the CMA's CAPM cost of equity range already sits within the CMA's MAR range, the MAR evidence does not indicate the point estimate should be set above the mid-point. This is before the 2% outperformance assumption is removed which further challenges any upward adjustment.

Debt-to-equity premium

35. The CMA acknowledges that under the fixed TMR approach, the debt-to-equity premium will typically fall when interest rates rise, and vice versa. The CMA further acknowledges that debt-to-equity premia would have been high during PR19 when interest rates were low, had this analysis been undertaken. Introducing debt-to-equity premium as a cross-check now, when the premium

has narrowed, undermines regulatory predictability and stability. Consumers funded a higher cost of equity because the stable TMR approach was used, on the basis that this approach would be maintained and any over-estimate would be off-set during higher interest rate periods. The current narrowing of the debt-to-equity premium is a natural and expected consequence of the stable TMR approach. It is not fair or justified to change methodology on TMR estimation or introduce debt-to-equity premium as a cross-check at the point when the expected offset would occur. We do not agree that the debt-to-equity premium should be introduced as a cross-check and do not agree that this can be used to justify a point estimate above the mid-point.

Welfare impacts of underinvestment

36. The CMA considers Ofwat's concern of under-investment to support aiming-up, and cites Ofwat's view that overall investor sentiment is low. We believe it is prudent that the CMA makes its own judgement on the likelihood of under-investment rather than adopt Ofwat's position. It is our view that the risk of the sector being unable to attract sufficient new capital is hypothetical rather than material. Regulated utilities are low-risk investments that offer stable, inflation-linked returns compared to regular equities, making them attractive to long-term investors. Investor appetite has always been strong for regulated utilities, and growth of the sector is an opportunity for investors due to the expanding RAV base. There is no evidence to suggest that under-investment is likely, and the level of over-aimining in the CMA's determination is not justified on the basis of a hypothetical and low-risk scenario.

37. Further, it would set a dangerous precedent to raise the cost of equity due to perceived low investor confidence. It may be that performance issues within the sector have led to low investor confidence. Setting the cost of equity point estimate above the mid-point in response to low investor confidence could be perceived as rewarding poor performance.

Asymmetry

38. The CMA acknowledges Citizens Advice' submission which noted that due to structural advantages the companies have, compared to regulators and those representing consumer interests, it is reasonable to assume that settlements are likely to favour companies. We argued that whether price control settlements are skewed against companies should be assessed in the context of historical performance. The CMA responds that its assessment of the balance of risk and return is set out in chapter 8, yet we feel this point is not addressed in chapter 8.

39. We further submitted evidence that the water sector has benefitted from a windfall gain due to the impact of inflation on the operation of the price control.[19] We estimated this windfall to be around £2bn across the sector for the first 4 years of PR19. This financial outperformance results in additions to the RCV not linked to performance and consumer outcomes. The RCV is higher than it would have been without the inflation windfall. This outperformance does not appear to be addressed in the CMA's balance of risk and returns assessment.

40. We additionally note the CMA's acknowledgement that "the ASM and the OAM provide greater protection against significant variation of returns compared to the previous price control"[20], yet this increased protection, which lowers risk, has not been reflected in the cost of equity calculation.

Setting the point estimate

41. As acknowledged by the CMA, UKRN guidance cautions against setting the point estimate above the mid-point. The UKRN states:

"as customers ultimately bear the cost of the allowed return, regulators agree there must be clear and convincing evidence to support that this is in their best interests where the cost of equity is set above a reasonable mid-point." [21]

42. The CMA acknowledges that "the decision to set a cost of equity above the mid-point is one which needs careful thought, and that aiming up should not be a default position."[22] and "given the relatively unique circumstances of this price control, a modest degree of aiming up on the cost of equity may overall be beneficial to customers."[23] It is our view that the CMA has not provided clear and convincing evidence that a point estimate 30 bps higher than the mid-point, which we do not perceive as moderate, is in the interest of consumers. Further evidence should be provided which quantifies the risk versus benefit to consumers.

[19] Third party submission for the water PR24 redeterminations. Citizens Advice. 2025.
[20] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. P.195.
[21] UKRN guidance for regulators on the methodology for setting the cost of capital. UKRN. 2023. p27.
[22] WATER PR24 REFERENCES Provisional Determinations Volume 4. CMA. 2025. P.125.
[23] Ibid. p.125.