

By email to:

Waterpr24references@cma.gov.uk

23rd December 2025

Dear Sir or Madam,

Response to Base Costs Modelling – Working Paper

I write in response to the Base Costs Modelling Paper published by the CMA on the 18th of December 2025. Whilst the modelling approach discussed in the paper does not directly affect Heathrow Airport, there are some important regulatory implications in the interpretation and application of the modelling that might have relevance to Heathrow given its similar regulatory framework.

In terms of this response, I do not raise any specific issues with the econometric models themselves. It appears that the CMA have undertaken a careful and thorough assessment. The comments I wish to raise are in respect of the potential interpretation and application of the results of the modelling to the cost allowances of companies.

Although the econometric approach has been developed carefully, the CMA should be careful in their application of the results of the modelling. There are likely to be many unmodelled factors that lead to Companies requiring either higher or lower costs than predicted by the model. The extent of this is inherently unclear, however given the scale of difference in costs identified by the model (e.g. between c26% below the average to 38% above the average for the water model) this is likely to be a significant issue. In particular:

- I do not consider that it is credible that the majority of the differences identified by the model indicate inefficiency. This would imply that management teams were leaving in some cases hundreds of millions of pounds per annum of potential savings on the table, despite the strong incentives to remove these. Whilst some inefficiency might be difficult to identify and remove, the scale suggested by the model is not credibly removable inefficiency;
- The explanatory power of the model, despite being higher than Ofwat's, is relatively low. It is important not to be misled by a high R-square as this simply reflects that the majority of variance is related to scale. Variances at company level are very high;
- Given the dispersion identified, it is likely that the majority of the identified cost differences between companies are explained by missing factors rather than differences in efficiency. Applying an upper quartile (UQ) cost target to all companies could therefore lead to unachievable cost targets for some of them.

The IWC recognised that over-relying on econometric approaches has led over time to sub-optimal outcomes for the water sector¹, and that their application could lead to a 'doom loop' of deteriorating service, performance and efficiency. It is therefore important to temper the results of the econometric approach with a recognition that companies with higher costs may require them for legitimate un-modelled reasons and consequently the results of the modelling should be applied with care.

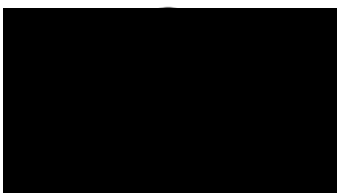
I recognise that use of the UQ efficiency as a target is in part intended to address this by ensuring that the efficiency level is not set to the level of the company identified by the model as the most efficient, as this is the company most likely to have missing factors that reduce its cost. This partially addresses the risk that the target is set by companies with missing favourable factors. However, this does not address the risk that the companies assessed as being least efficient are likely to have several missing factors that lead to their costs being higher.

The key approach the CMA could adopt to help address this uncertainty would be to set each company's cost allowance as a proportion of the UQ baseline and their actual costs, for example the cost allowance could be set at the mid-point between these. Determining the appropriate proportion will require judgement. Consideration of the likely dispersion of true efficiency differences between companies, given the strong incentives in place, could be helpful in this. In my view, it is unlikely that the true variation in efficiency between companies is greater than 10% or so as excess costs beyond this are likely to be easier to identify and remove. If this is correct, and noting the 64% range identified by the water model, perhaps only around 1/6th of the variance in cost could safely be ascribed as inefficiency. This suggests that using the mid-way point between actual costs and the UQ frontier could be unduly challenging.

I would welcome the CMA giving this issue some consideration in its final decision, as it could set an important precedent both for Ofwat's replacement in implementing the IWC's recommendation to balance econometric methods with a supervisory approach, and for the weight to place on econometric modelling in other sectors.

I am happy to discuss these issues further with the CMA team if they consider it would be helpful.

Yours sincerely,



Mike King, Director of Regulation and Economics
Heathrow Airport Limited

¹ IWC, Para 417