Citizens Advice response to UKRN Cost of capital: Review of guidance - consultation

Introduction

Citizens Advice welcomes the opportunity to respond to this consultation as part of its statutory role to represent energy consumers in Great Britain. Our response is not confidential and may be freely published.

Citizens Advice agrees with a large part of the UKRN Consultation, particularly the aims to increase transparency and consistency across regulators when setting the cost of capital. We also support many of the recommendations, which we set out below.

However, Citizens Advice is concerned that the consultation approach may not provide an opportunity for outcomes to strike a fair balance between the interests of consumers and investors. This is because the recommendations largely replicate the 2023 original draft guidance. As we set out at the time[1], those recommendations sought to consolidate the existing methodologies of regulators, which reflect the significant asymmetries between consumers and investors.

Regulated companies have an unambiguous interest in the allowed cost of capital being as high as possible and devote considerable resources to this end. Consumer bodies on the other hand are interested in getting the *right* cost of capital to attract capital at value for money, have fewer resources and do not possess effective appeal rights. Continuing to base recommendations on established or proposed positions that reflect these asymmetries will not result in setting a fair or proportionate cost of capital.

Cross-checks are a useful tool in assessing whether the cost of capital is in the right ball-park, and we welcome the criteria for assessing cross-check suitability in the consultation. However, we believe there is a further distinction to be made between direct, observable market evidence (objective) and indirect, model-driven metrics (subjective) cross-checks and how these are treated. For

[1] Citizens Advice, response to UKRN guidance for regulators on the methodology for setting the cost of capital, November 2022

the objective cross-checks, based on observable market evidence regulators should be required to provide an explanation for any divergence. If a plausible explanation cannot be provided then changes to the estimation must be adopted. For example, observable and objective energy transaction evidence indicates the CAPM cost of equity set too high. Here, the divergence between real-world transaction evidence and the CAPM model would need to be explained by regulators, or an alternative estimation approach adopted.

We welcome the review of the TMR approach and ask the UKRN to ensure consumer perspectives are factored into the guidance. We caution against any changes to the TMR being made on the basis of '*the backdrop of plans to attract significant infrastructure investment into the UK*'[2]. Firstly, compelling evidence would be required showing there is a material risk of under-investment, which has not been provided. Rather, real-world transaction evidence indicates that UK regulated companies are highly attractive to investors. Secondly, the TMR methodology should be underpinned by empirical evidence for the approach, and maintain fairness to consumers. Changing the methodology because macroeconomic conditions are less favourable to investors is not robust or fair, particularly since consumers funded high returns during low-interest periods.

In conclusion, Citizens Advice asks the UKRN cost of capital taskforce to:

- Redefine the scope of the consultation to identify the *correct* approach to estimating the cost of capital, which can then be applied consistently across regulators.
- Make recommendations based on empirical evidence, for instance, from findings within the UKRN's 2018 cost of capital study. Where there is insufficient evidence, a new study should be commissioned.
- Recognise qualitative differences across cross-checks and recommend that regulators explain any divergence between the CAPM estimated cost of equity and objective, observable evidence, or change approach if an explanation cannot be provided.

Question 1: Do you agree with the proposed recommendations in this document?

Consultation aims are not in line with consumer interests

[2] UKRN, Cost of capital guidance consultation, June 2026, p.3

We welcome the opportunity to contribute our views within this consultation. The consultation sets out that the intention of the guidance is:

- *'To increase the consistency in how regulators approach calculating the cost of capital, and*
- *To increase the transparency of the underlying assumptions and processes for setting cost of capital'* [3]

Citizens Advice strongly supports the goals of increasing transparency and consistency in setting the cost of capital across regulators. However, we have concerns that these aims alone do not provide scope to reflect consumer views adequately.

The guidance notes that '*the provisional view of regulators is that most recommendations of the original draft guidance remain appropriate, but there is scope to align further on the detail behind these recommendations to increase consistency and transparency.'*.[4]

In our response to the 2023 original draft guidance consultation, we set out our concerns with the consultation process and proposals. In the consultation it was noted that the recommendations '*bring together and consolidate existing methodologies*'.[5] We raised concerns that this approach was not consistent with the Government's expectation at the time that '*the methodology that regulators use to control prices [creates] a fair and effective process that [...] balances the interests of investors and consumers*'.[6]

This is because the existing positions of regulators reflect substantial asymmetries between consumer stakeholders on the one hand, and company stakeholders on the other. Specifically:

- Commercial interest: Government and consumer bodies have a common interest in setting the right cost of capital (i.e. neither too high nor too low). In contrast, investors (and companies) have an unambiguous interest in the allowed cost of capital being as high as possible.
- Resources: Given the clear commercial interest to secure the highest possible allowed cost of capital, the regulated companies will devote considerable resources, both internally and via external advisers, to

---

[3] UKRN, Cost of capital guidance consultation, June 2026, p.8
[4] UKRN, Cost of capital guidance consultation, June 2026, p.4
[5] UKRN, cost of capital guidance, 2023, p.4
[6] BEIS, Economic regulation policy paper, January 2022

influence this outcome. Such resources can be several orders of magnitude greater than consumer bodies can employ.

- Regulatory process: While regulatory processes should seek to address the above asymmetries, in practice they can make things worse. In particular, it is far harder, or impossible, for stakeholders other than the regulated companies to appeal regulatory determinations.

Since the 2026 draft guidance largely reflects the 2023 guidance, this risks reinforcing these asymmetries. Aiming only for *consistency* in how regulators approach calculating the cost of capital prevents consumer views from being taken into account. We believe instead the guidance should seek to identify an approach which leads to the *right* cost of capital, i.e. one that is fairly balanced between attracting investment and providing value for money for consumers.

It is particularly important that the UKRN guidance reflects an objective assessment of the *right* cost of capital because of the weight which is placed upon the guidance within regulatory price controls. The formal price control consultative processes are the main means consumer groups have to represent consumer interests. However, consumer views can be effectively disregarded within formal price control decisions by simply deferring to UKRN guidance. The guidance itself, being the consolidated views of the regulators, will reflect the significant asymmetries between the representation of consumer and company interests.

If formal price control decisions are effectively to be made on the basis of the UKRN guidance, then the guidance itself requires a formal process through which consumer interests can be reflected. However, the aims of this consultation do not provide that opportunity.

Citizens Advice supports the following recommendations

Notwithstanding our general concerns above, there are several of the UKRN recommendations that Citizens Advice support, namely:

- Recommendation 1 – Notional company: Regulators should continue to estimate the allowed rate of return in price controls based on the weighted average cost of capital for a notionally-financed firm within their sector.

- Recommendation 2 – CAPM: Since the cost of equity is not directly observable, it must be estimated using a widely accepted method.

Regulators should continue to use the capital asset pricing model (CAPM) as their primary approach for estimating the cost of equity.

- Recommendation 3 - Gearing: The notional gearing assumption should reflect the regulator's assessment of the balance of risks facing the regulated company, a wide range of benchmarks on gearing levels and overall regulatory policy objectives, not just that of the actual company (or companies) in question.

- Recommendation 4 – Risk-free rate: To estimate the real risk-free rate (RFR) within the CAPM, regulators should use recent yields on the index-linked gilts, with a maturity which matches the assumed investment horizon for their sector.

We support the data cut-off date of no further than 6 months from the publication of final determinations to derive estimates for the risk-free rate.

- Recommendation 7 – CAPM point estimate: The RFR, TMR and (re-levered) equity beta assumptions should be combined using the CAPM to produce a cost of equity range. The mid-point of the range should be used as the central estimate for the CAPM cost of equity.

- Recommendation 8 – Cross-checks: Cross checks may be used to sense check the CAPM derived point estimate. However, regulators should only deviate from the midpoint of the CAPM cost of equity range if there are strong reasons to do so.

We support the use of cross-checks and agree that regulators should only deviate from the midpoint of the CAPM range if there are strong reasons to do so. We support the proposed framework for assessing the cost of equity cross-checks on the grounds of defensibility and implementability. It is our view that cross-checks should be further distinguished between direct, observable market evidence (objective) and indirect, model-driven metrics (subjective).

Regulated utility transaction Market-to-Asset ratios (MARs) are a directly observable and objective cross-check by which to assess CAPM estimates. They represent revealed market preferences based on actual capital deployed in regulated companies. Implying a cost of equity from transaction MARs starts with a real-world market valuation of the relevant sector, and uses price control parameters only. The objectivity of MAR transactions make them qualitatively stronger than other cross checks. For instance, the Infrastructure Fund implied IRR includes a range of sectors with varying risk-profile and relies heavily on manager reported Net Asset Value (NAV) discounts rates which are mark-to-model (rather than mark-to-market) assessments.

For more objective cross-checks, based on observable market evidence regulators should be required to provide an explanation for any divergence. If a plausible explanation cannot be provided then changes to the estimation should be adopted.

Energy network transaction MAR evidence suggests that the CAPM methodology, based upon UKRN guidance, results in a cost of capital that is set too high. Recent examples include the announcement that Engie will acquire UK Power network companies at a Market-to-Asset ratio (MAR) premium of 50%. In August 2024, Iberdrola acquired an 88% stake in Electricity North West at a premium of 60%. In July 2024, Macquarie Asset Management acquired the remaining 20% equity interest in National Gas from National Grid at a premium of 26%. Ofgem has itself noted that '*it is difficult to accept that large MAR premiums can be justified by assumptions other than higher than required returns or lengthy and consistent expected outperformance*'. [7]

Ofgem's ED3 SSMD analysis reveals an average implied cost of equity from the recent energy network transactions of 3.95% (ranging from 3.50% for ENWL to 4.66% for National Gas). These figures include a 1% outperformance upward adjustment, which we view as generous since transaction values already incorporate outperformance expectations, indicating the true implied cost of equity is even lower. The MAR implied cost of equity sits drastically below Ofgem's CAPM estimated mid-point of 6.08%. A gap between the CAPM cost of equity and observed transaction evidence by over 210 basis points indicates that the CAPM systematically over-estimates the required cost of equity. Regulators must be able to explain the divergence with objective, observable evidence, or change the estimate approach if a plausible explanation cannot be provided.

Further, we do not support the use of a debt-to-equity ratio cross-check. The narrowing of the spread between the cost of equity and the cost of debt during high-interest rate periods is a natural byproduct of the stable TMR approach. A stable TMR intentionally captures counter-cyclical equity risk premia, where ERP compresses as the risk-free rate rises, which is supported by empirical evidence.

---

[7] Ofgem, RIIO-3 draft determinations - finance annex, July 2025, p.64

Using a debt-to-equity ratio cross-check risks conflating expected cyclical fluctuations with a cost of equity that is dislocated from market requirements.

We agree with the guidance that caution should be taken with international comparisons for the reasons set out in the consultation. For instance, US returns are not a suitable comparator to UK returns due to the lack of inflation protection in the US.

We strongly support the recommendation that regulators should only deviate from the midpoint of the CAPM cost of equity range if there are strong reasons to do so. Any deviation from the mid-point would require compelling evidence and should be considered only in exceptional circumstances. We believe introducing a standard assessment framework would create a risk that the bar for deviating from the mid-point could be lowered.

We do not support several of the assessment criteria set out:

- the welfare impact of under-investment - before any assessment of the welfare impacts of under-investment, compelling evidence would first need to be provided that there is a *material risk* of under-investment. The current real-world transaction evidence indicates that UK regulated utilities are highly attractive investments.
- asymmetry in the package of incentives - no assessment on asymmetry within the package of incentives can be under-taken without regulators providing the probability of achieving rewards and penalties. In any case, any asymmetry within the package of incentives should be dealt with at source, not through the cost of equity.
- asymmetry in the choice of parameters - were this to be adopted it would need to be applied consistently in both directions. For instance, for TMR estimation, the consultation recognises that '*while in principle the market portfolio should include all investible securities, regulators have pragmatically tended to use a broad index of sterling-denominated equities as a suitable proxy, for instance the UK FTSE-All Share.*'.[8] The CMA has acknowledged that '*such an approach may find that the evidence supports a lower TMR than is estimated under the current standard approach of using equity returns'.*[9] However, historically no adjustment to the point estimate has been made on this basis.

[8] UKRN, Cost of capital guidance consultation, June 2026, p.21

[9] CMA, Final determination Volume 2A: Joined Grounds: Cost of equity, 2021, P.71

- financeability - regulated companies and regulators have multiple levers to address any financeability concerns. The cost of equity should not be adjusted on the basis of financeability.

- Recommendation 9 – Cost of debt: Regulators should estimate an allowance for an efficient company under the notional financial structure, with actual debt costs suitably benchmarked against other market evidence.

We support the guidance recommending that regulators should have regard to more recent evidence on inflation dynamics, for instance, the OBR's assessment of a long-term CPIH-CPI wedge of 0.4%. Continuing to deflate the nominal cost of debt by 2% leads to an over-estimation of the real cost of debt, and a windfall to companies.

Citizens Advice does not support the following recommendations

- Recommendation 6 – Equity beta: Regulators should estimate equity beta for the notional company using comparable listed companies and standard regression techniques (i.e. ordinary least squares (OLS)). Where the listed comparator has different gearing to the notional company, regulators should continue to de-lever and re-lever the raw equity beta.

Length of estimation window, and frequency of data

We are concerned that 'standard regression techniques' may result in substantial biases in estimating the true equity beta which reflects the actual relevant risks facing the regulated companies.

An Ofgem-commissioned report by Donald Robertson[10] noted that if beta is time-varying, then an OLS regression assuming a constant coefficient is mis-specified and the model subject to heteroscedasticity. Robertson found '*overwhelming evidence*' that beta is time-varying and argued that GARCH estimation may be more suitable as it '*provides a good estimate of the long run parameter and also models the short run dynamics of beta*'. Robertson further found that using lower frequency data over longer data samples for OLS estimates eliminated a lot of the heteroscedasticity and estimates were more in line with the long-run estimates from GARCH models. We suggest that use of a

[10] Donald Robertson, Estimating beta, April 2018

GARCH model is considered and/ or use of lower frequency and longer-sample data if OLS is used.

In our response to the 2023 draft guidance, we recommended that weight should not be placed on short-run betas, due to upward bias from index-investing. In response, the UKRN taskforce 'consider[ed] that more research is needed to quantify the size of this distortion, before considering whether it justifies excluding betas with shorter estimation windows.'. We would expect this research to now have been completed, or for it to be completed as part of this process. It is not appropriate to leave a known distortion, recognised by the UKRN at a previous review, unquantified and unaddressed.

Similarly, we have previously raised that the effect of estimating equity betas by regression against UK equity market indices – rather than indices of all (global) assets is itself likely to create an upward bias in UK regulated company beta estimates. This reflects that movements in UK regulated company share prices will be far more correlated with UK share prices generally than with movements in all global asset prices. This matters because equity betas are intended to reflect the correlation between an individual equity's systematic risk and the systematic risk of all assets, not just a small subset of such assets. This is also especially relevant given that the investors in UK regulated companies are themselves among the world's largest diversified investors, investing in all asset classes across all geographies, of which UK equities comprise only a small component. The use of local, rather than world, betas therefore puts upward pressure on the estimation.

The UKRN 2023 guidance notes that using betas estimated against a World index '*is in practice beset with difficulties*' and instead supports '*the more pragmatic and implementable*'[11] approach of estimating betas from local markets. However, it is possible that doing so introduces upwards bias into the beta estimation. This potential issue should be recognised in the 2026 guidance. Analysis should be undertaken to understand whether the pragmatic approach does create an upwards bias in the estimation.

Further, the consultation makes reference to choosing a data cut-off no further back than 6 months from the publication of final determinations to derive estimates for the risk-free rate and equity beta. During RIIO-3 we raised

[11] UKRN, cost of capital guidance, 2023, p.23

concerns[12] around out-dated asset beta data being used to determine the equity beta estimate. We support the data cut-off recommendation to prevent this. The guidance should recommend this cut-off date is applied consistently across all financial variables within the CAPM. In relation to the RIIO-3 example, this would require updating the underlying asset beta values and the range in line with the cut-off date.

Guidance on comparator inclusion

We believe more guidance is needed on identifying listed comparators that can proxy for the notional company which requires an estimate of beta. Specifically, criteria must be set out to establish whether a comparator is a suitable proxy for the notional company. Regulators should explain why their choice of comparators are appropriate, whether there are any risks that make them potentially unsuitable, and how such risks are mitigated.

In RIIO-3, Ofgem departed from established regulatory precedent by introducing Spanish and Italian comparators into the equity beta estimation. At ED3, Ofgem justified their inclusion on the basis of similar regulatory regimes to the UK and noted the selected companies are predominantly regulated, have BBB+ / A- S&P Global credit ratings, and market capitalisations between €4bn and €20bn, ensuring sufficient trading liquidity. However, despite these similar characteristics the Italian company 10 year betas - Snam (0.44) and Terna (0.43) - sit significantly higher than the Spanish company betas - Enagas (0.36) and Red Electrica (0.33).[13] This brings into question whether there are other risk factors driving the Italian betas, for instance, greater political or regulatory risk. Whilst the Italian betas were included without an explanation being provided as to why they were so high, Portuguese company REN was disregarded for having a beta that was too low.[14] This is inconsistent and requires further justification.

In the RIIO-2 appeals, the CMA recognised that European comparator equity betas may be subject to 'noise' from: non-regulated activities within comparator firms, issues with the quality of the data due to volatility in betas over time or illiquid share trading, and differences in the regulatory environment. The CMA determined that '*there is complexity and a requirement for a large number of judgements to be made in performing European comparator analysis*' and were '*not*

---

[12] Citizens Advice, response to Ofgem's Statutory Consultation on the RIIO-3 Licence Drafting modifications, January 2026
[13] Ofgem, RIIO-3 Draft Determinations - Finance Annex, July 2025, p.56
[14] Ofgem, RIIO-3 Draft Determinations - Finance Annex, July 2025, p.57

persuaded that inclusion of such data would have improved the robustness of GEMA's beta estimation.'[15]

The guidance should therefore recommend regulators set out clear justifications for their inclusion of comparators, explain or exclude any anomalies consistently, and conduct an assessment on their suitability as comparators to the UK regulated sector.

Greater alignment should lower financing costs

Finally, the consultation notes that *'greater alignment should improve the predictability of regulatory decisions and may reduce the perceived risk of investing in UK infrastructure. This should in turn benefit consumers by increasing the attractiveness of investing in UK regulated sectors and lowering these sectors' financing costs.'*[16]

We agree that greater alignment will improve the predictability of regulatory decisions and should reduce the perceived risk of investing in UK infrastructure. This lower risk must then be reflected in a lower equity beta. We recommend that the UKRN explains how regulators should reflect reductions in risk from improved predictability in lower equity betas.

Question 2: When determining the range for TMR, to what extent should UKRN members place weight on estimates of TMR derived additively from estimates of the ERP combined with the RFR?

We support the CMA's call for a targeted review of the approach to TMR to ensure estimation methodologies remain empirically robust. However, we do not support placing weight on estimates of TMR derived additively from estimates of the ERP combined with the RFR. This would be a significant change in regulatory precedent and would require compelling evidence. However, we do not believe there is sufficient evidence to justify a change. Further, the evidence in the energy sector suggests that networks are considered highly attractive investments. No evidence has been provided that there is a material risk of under-investment in the networks. It is our view that placing weight on stable ERP estimates would not be in the interest of consumers.

The evidence does not support a stable ERP approach

[15] CMA, Final determination Volume 2A: Joined Grounds: Cost of equity, 2021, P.130.
[16] UKRN, Cost of capital guidance consultation, June 2026, p.8

As noted in the consultation, expert opinion in the Wright et al. (2018)[17] cost of capital study and other studies have found the empirical basis for a stable ERP to be weak, and the basis for a stable TMR to be stronger. They state that the basis for a stable ERP:

'*has been further undermined by more recent evidence that risk premia are countercyclical.'*[18]

The stable TMR approach reflects this behavior naturally. In contrast, deriving TMR by combining a stable ERP estimate with a higher RFR forces overall market returns to rise one-for-one with interest rates, violating counter-cyclicality.

Further, the consultation points to potentially 'counter intuitive' scenarios under a stable TMR approach where rising interest rates lead to a falling or unchanged cost of equity for high-beta or unit-beta firms. However, this mechanical outcome for theoretically high or unit beta companies is irrelevant to low-risk, regulated utility companies. It has been documented previously that '*on the basis of a priori reasoning the risk profile of cashflows for regulated businesses is almost entirely idiosyncratic.*'[19] i.e. implying a theoretical equity beta of zero. A unit or high beta is infeasible for regulated companies. Where the beta is below one, the stable TMR approach produces outcomes as intended.

The approach to estimating TMR should be based on evidence, and should remain constant under fluctuating macroeconomic conditions. The UKRN 2023 guidance recognises that:

'*In the low interest rate environment following the 2008 Financial Crisis, such an approach likely overestimated the TMR expected by the market. This is in part because there is empirical evidence of a positive relationship between real interest rates and real returns on equity, for example, as shown in the DMS Yearbook.*'[20]

In its PR24 provisional determination, the CMA further recognised that:

'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.'[21]

[17] UKRN, Cost of capital guidance consultation, June 2026, p.22
[18] Wright et al., Estimating the cost of capital for implementation of price controls by UK Regulators, 2018, p.39
[19] Wright et al., Estimating the cost of capital for implementation of price controls by UK Regulators, 2018, p.54
[20] UKRN, Cost of capital guidance, 2023, p.19
[21] CMA, Provisional Determination Volume 4, 2025, P.62

The CMA also recognised 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*'.[22]

The CMA's decision to place some weight on a stable ERP estimate is at odds with its own assessment. Consumers have funded high returns under the stable TMR approach during low-interest rate periods, on the basis that the through-the-cycle approach would be maintained under periods of high-interest rate periods. During the period of regulatory consensus around the stable TMR approach since 2010, 79% of the time the Bank of England's bank rate has been below 1%, whilst it has been above 4% only 12% of the time.[23] Changing the methodology when shock-induced short term macroeconomic fluctuations are less favourable to returns is neither consistent nor robust. No such concerns with methodology were raised over the past decades when the macroeconomic environment was more favourable to investors at the expense of consumers. It would be unfair to consumers to make a methodological change when the macroeconomic environment is less favourable.

Were a change in methodology to be considered it would require both sufficient evidence that it would improve the estimation, and crucially would need to be implemented at a suitable time, once a more balanced and complete macroeconomic cycle had passed, to be fair to consumers.

Both regulators and investors stress the importance of predictability and stability in the regulatory regime. However, considering a change in methodology because the macroeconomic climate yields less favourable returns undermines these principles. In practice, shifting goalposts under changing market conditions implies that 'predictability' is being redefined as a mechanism to protect returns from falling. If this asymmetric logic reflects the true position of regulators, it should be stated transparently. Any asymmetric protection would naturally lower the risk profile of regulated utilities and would need to be reflected in a lower equity beta.

We recommend that the empirical evidence put forward in the comprehensive Wright et al. (2018) study be followed, or an updated study be commissioned. On the basis of currently available evidence, we agree with the guidance not recommending a wholesale switch towards a stable ERP approach, which as

[22] CMA, Provisional Determination Volume 4, 2025, P.63
[23] Bank of England Database, dataset YWMB47D

noted, would undermine the past 16 years of regulatory consensus, with limited empirical support. We do not believe it would be appropriate to consider a hybrid approach to TMR estimation by placing weight on both the stable TMR and stable ERP approaches. For this approach to be adopted, sufficient evidence would need to be provided that indicates a stable ERP approach would improve the accuracy of the estimation, rather than being justified on the basis of increasing investor returns.

The evidence does not indicate there is a material risk of under-investment

In suggesting a review of TMR, the CMA asked whether this would be of benefit to consumers '*given the backdrop of plans to attract significant infrastructure investment to the UK*'.[24] However, the real-world evidence in the energy sector demonstrates that allowed returns in networks are already highly attractive. Meanwhile, no evidence has been provided that there is material risk of under-investment in the sector. There is a long-list of network companies being acquired at a significant premium. The Engie acquisition of UK Power Networks was announced earlier this year at a Market-to-Asset ratio premium of 50%, under the *current* TMR approach and without any commitment to change the methodology. Further examples include Iberdrola acquiring an 88% stake in Electricity North West (ENWL) at a premium of 60% in August 2024.

Ofgem has recognised that '*it is difficult to accept that large MAR premiums can be justified by assumptions other than higher than required returns or lengthy and consistent expected outperformance*'.[25] This demonstrates that allowed returns estimated under the current CAPM methodology are generous and highly attractive to investors. Making a methodological change to increase allowed returns further would be unjustified and not in the interest of consumers.

Were there to be compelling evidence that under-investment posed a material risk, this should be assessed on a case-by-case basis within sectors, and reflected in the choice of point-estimate, not used to justify methodological changes within individual CAPM components for all regulators. In its PR24 re-determination, the CMA set both a point-estimate 30 bps above the CAPM mid-point *and* made a methodological change to increase the TMR estimate. This represents double-counting and leads to consumers over-compensating investors. The TMR methodology should not be amended purely to increase

---

[24] UKRN, Cost of capital guidance consultation, June 2026, p.3
[25] Ofgem, RIIO-3 draft determinations - finance annex, July 2025, p.64

returns when there are other available mechanisms for adjusting the cost of equity, were compelling evidence provided to justify this.

The TMR may already be over-estimated

It is particularly important that the TMR methodology is not intentionally altered to increase returns as it is likely already over-estimated. This is because TMR estimates should not just be based on the average returns on UK equities, but ideally on the average returns on a wider and more diversified portfolio of investments, namely, including bonds, property, infrastructure, private equity, and other such assets that are all readily available to the typical investors in UK energy and water network companies. Such a portfolio is necessarily more diversified than UK listed equities alone, therefore a much better fit for the CAPM's requirement that the 'market portfolio' should represent the most diversified (and readily available) portfolio of investments to relevant investors. Such a portfolio is also likely to exhibit lower average returns than equities alone, owing to the inherently geared nature on average of equities.

This position was accepted by the CMA: '*theoretically, the TMR should reflect the return on all assets in the economy, and that there is some evidence suggesting that total returns across all asset classes are lower than those on equities alone, and potentially materially lower*'.[26]

The consultation notes that '*while in principle the market portfolio should include all investible securities, regulators have pragmatically tended to use a broad index of sterling-denominated equities as a suitable proxy, for instance the UK FTSE-All Share.'*.[27] However, if there is a risk that the pragmatic approach leads to an over-estimation of the TMR, this should be quantified and addressed.

There is a further risk that the use of historical data for the ex post and ex ante approaches is likely to over-estimate the TMR. For instance, in the PR19 redeterminations the CMA noted that many academic studies conclude that the ex post approach is likely to over-estimate required returns. The CMA cites Mehra and Prescott's (1985) observation that:

'the high historical returns provided by equities relative to government bonds are inexplicable in the context of standard economics models that describe risk'[28],

and Blanchard, Shiller and Siegel's (1993) conclusion that:

---

[26] CMA, Final determination Volume 2A: Joined Grounds: Cost of equity, 2021, P.71
[27] UKRN, Cost of capital guidance consultation, June 2026, p.21
[28] CMA, PR19 appeal final report, p.822

'*the ex post ERP appears far in excess of what is justified by standard asset-pricing models with reasonable levels of risk aversion*'[29].

Analysis of the risk of over-estimation within the current approaches should be included in the targeted review of the TMR.

Question 3: If supportive of placing weight on TMR estimates relying on ERP, which approaches to estimating ERP should UKRN members consider adopting?

For the reasons outlined above we do not support placing weight on TMR estimates relying on ERP.

Question 4: Do you have views on potential issues that UKRN members may want to consider for further investigation?

---

[29] CMA, PR19 appeal final report, p.822