3rd Floor
1 Easton Street
London WC1X0DW
Tel: 03000 231 231

citizensadvice.org.uk

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Third party submission for the water PR24 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. Any unjustified returns for companies arising add unfair cost to consumers' bills (at the time of an ongoing cost of living crisis). We also believe unjustified returns will erode the credibility of the regulatory regime and so damage customer trust. Trust will be vital to future investment including for net zero delivery. This must mean that there is a high burden of proof to allow companies additional money.

4. We have not attempted to address all issues raised but instead comment on a number of areas that are broadly consistent across the various statements of case:

a. *Current performance (PR19)*. Our analysis shows the water sector, as with energy networks, has received windfall gains arising from high-inflation resulting in general outperformance.

b. *Cost of equity*. We assess the proposed value is likely to be higher than required, both by comparing to the energy sector and through structural upward bias in the detailed calculations.

c. *Fair bet*. We believe much of the reasoning the CMA applied for not allowing Ofgem to make a downwards adjustment for expected outperformance applies here (to changes that end in upwards adjustments).

d. *Updated data*. Redeterminations should be based on the information at the time of the original decision. To do otherwise allows companies to refer to the CMA only when new data is in their favour.

e. *Transparency*. The CMA should do all it can to help allow third parties to engage with proceedings.

5. We have not sought to identify additional issues that the CMA should consider. This should not be taken as a view that these do not exist.

6. This should all be seen in the context that UK regulated companies have generally and consistently enjoyed high returns through regulatory settlements that have proved too generous. This is why the returns enjoyed by network companies have come under considerable scrutiny for a number of years. Allowing windfall gains, on top of an already generous settlement, is likely to bring the overall regulatory regime under further pressure. A stable regulatory regime is important for consumers, particularly with the increase in investment required for net zero.

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Contact details

Citizens Advice
3rd Floor
1 Easton Street
London WC1X0DW

FAO

Andy Manning, Head of Energy System Transformation

andy.manning@citizensadvice.org.uk

Merle Jamieson, Economic Regulation Specialist

merle.jamieson@citizensadvice.org.uk

PR19 performance - impact of high inflation

Summary of outperformance

7. The statements of case broadly attempt to give the impression that there is general underperformance in PR19, for example, Anglian Water[1] reports the sector has underperformed on ODI RoRE by 69 bps. However, the water sector has also benefitted from a windfall gain due to the impact of inflation on the operation of the price control. Citizens Advice has recently published evidence which analysed the windfall in the energy sector and estimated it to be in the order of £4bn[2] within the current set of price controls. We estimate the equivalent windfall in the water sector[3] to be of the order of £2bn[4] for the first 4 years of the PR19 period.

Impact of inflation

8. Regulatory Capital Values (RCV), made up of equity and debt, are indexed to outturn inflation[5]. However, in reality a proportion of actual debt is charged at a fixed rate rather than being index-linked (and so costs do not move with inflation). This means that, in periods of high inflation as experienced during PR19, additional RCV is created over and above the actual increase in nominal debt, which it finances.

9. The intent of the regulatory regime is to protect both consumers and network companies against inflation by ensuring equity values are unaffected by outturn inflation. However, the impact of inflation on debt has provided an additional equity return on top of the adjustment intended to provide that protection. This is a windfall. This is paid for by consumers to companies through run-off allowances over the regulated asset life. However, companies are able to leverage the additional RCV to raise money, meaning the benefit to companies is immediate.

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[1] Anglican Water: statement of case , March 2025, Page 2
[2] Debt to society, Citizens Advice, February 2025
[3] Analysis based on company Annual Performance Reports (APR) and tables, with support from Ofwat
[4] between 2020/21 and 2023/24, in year-end nominal prices
[5] CPIH

10. Based on the water companies' actual gearing ratios, the RCV indexation uplift for debt between 2020/21 and 2023/24 across all water companies was £13.5bn, in nominal year-end prices. Deducting the total indexation charge for RPI-linked borrowing (£8.5bn), the total indexation charge for CPI-linked borrowing (£859 mn), and an implicit 2% inflation charge[6] on the fixed-debt (£2.1 bn), leaves the £2bn windfall across the companies. Of this windfall, £542 mn was received by the 5 disputing companies:

	2020/21 - 2023/4 nominal year-end prices (£ mn)				
	Debt-financed RCV indexation uplift [7]	RPI indexation actual debt charge [8]	CPI indexation actual debt charge [5]	Fixed-rate debt implicit inflation charge [5]	Windfall (RCV indexation uplift - actual charges)
Anglian Water	1390	975	241	162	12
Northumbrian Water	740	309	24	158	250
South East Water	266	184	0	31	51
Southern Water	921	797	0	113	11
Wessex Water	576	242	0	116	218
Total	3893	2507	265	580	**542**

11. We believe this is likely to be an underestimate of the windfall for PR19. Inflation remained above the long-term assumption[9] in 2024/5 which will generate further outperformance. Also, we note that CPIH (latest value 3.4%[10]), used by Ofwat for RCV indexation, is tracking higher than CPI (2.6%) and RPI (3.2%) meaning further windfall gains can be expected. This also means there is the potential for inflation-related outperformance to continue into the PR24 period (noting that in energy, Ofgem has made changes to fix this issue for the next set of energy network price controls).

[6] Ofwat's cost of debt allowance deflates the nominal debt coupon by 2% to derive its CPIH-real allowance
[7] Data from company 2023/24 RCV update tables
[8] Borrowing data from annual APR data tables - 1E. Floating debt has a negligible impact and is excluded. RPI and CPI inflation charges calculated using annual December YoY ONS inflation figures. An implicit inflation charge assumption (2%) has been applied to the fixed-rate debt.
[9] Can be assumed to be 2%
[10] Inflation and price indices, ONS, April 2025

Conclusions

12. This 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 additional shareholder value needs to be fully taken into account when considering the PR19 performance position of the companies. It is not picked up in Ofwat's measure of regulatory return on equity (RoRE), as published in its Monitoring Financial Resilience reports, which track the financial performance of the sector. Beyond clarifying the performance position of the companies, this is important to recognise in this redetermination for a number of reasons:

    a. It demonstrates the structural asymmetry of price control arrangements. We believe that companies would have sought relief had the opposite effect occurred (i.e. very low inflation causing financial underperformance).
    b. Operational performance should be interpreted in the context of this overall performance. As this windfall gain is delivering significant additional shareholder value, different business decisions can be taken towards operational performance i.e. initiatives that pay off over longer periods of time can be prioritised as the need for short-term outperformance to satisfy shareholders is reduced.
    c. Companies should be in a better position to manage new investment, due to the RCV additions. This is not reflected in the cost of equity calculations. We do not accept that this windfall should not be taken into account in setting notional gearing and, given wider concerns about financial resilience, as a minimum companies should use this to reduce gearing levels.

Cost of equity

Comparison to energy

13. By comparing the energy sector, we believe the Ofwat cost of equity is generous to the companies. Taking the early view of cost of equity from RIIO3 Sector Specific Methodology Decision[11], and recalculating on the basis of the 55% gearing level employed by Ofwat, this gives an Ofgem range of 4.2% - 5.8%. The PR24 value (5.1%) sits above the mid-point for this range.

Evidence that energy values are too high

14. However evidence, including from recent transaction activity, is that this cost of equity is likely to be too high. In June 2022, Ofgem published a MAR inference model within its electricity distribution price control draft determination (ED2)[12]. Ofgem used this MAR model to infer a CoE from recent transactions involving monopoly network companies. Ofgem found that the transactions are consistent with a CoE range of 3.2% to 3.9%[13].

15. Analysis below has applied Ofgem's MAR inference model to the recent transaction of ENWL[14] in August 2024 in a table alongside the calculations Ofgem presented in its ED2 draft determinations.

Ofgem's Market to Asset Ratio inference model and ENWL transaction

Component	WPD	Bristol	SGN	NGGT	ENWL	ENWL	ENWL	Formula
Baseline allowed ROE	4.65%	4.09%	4.55%	4.55%	5.43%[15]	5.43%	5.43%	A
Expected Outperformance	2.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	B
Real ROE	6.65%	5.09%	5.55%	5.55%	6.43%	6.43%	6.43%	C = A + B
CPIH	2.00%	2.00%	2.00%	2.00%	2.00%[16]	2.00%	2.00%	D
Nominal ROE	8.65%	7.09%	7.55%	7.55%	8.43%	8.43%	8.43%	E = C+D

[11] RIIO-3 Sector Specific Methodology Decision - Finance Annex, Ofgem, July 2024, Page 99
[12] RIIO-ED2 Draft Determinations – Finance Annex Ofgem, June 2022. Page 181
[13] RIIO-ED2 Draft Determinations – Finance Annex, Ofgem, June 2022. Page 44
[14] Acquisition of Electricity North West, Iberdrola, August 2024
[15] RIIO-3 SSMD Allowed Return on Equity Early View Summary Calculations Ofgem, July 2024
[16] RIIO-3 SSMD Finance Annex Ofgem, July 2024

RAV Growth (Real)	2.00%	2.00%	2.00%	0.00%	0.00%	1.00%	2.00%	F
RAV Growth (Nominal)	4.00%	4.00%	4.00%	2.00%	2.00%	3.00%	4.00%	G = D + F
Dividend pay-out ratio	70%	61%	64%	100%	100%	84.45%	68.90%	H = 1 - F/C
Dividends paid	4.65%	3.09%	3.55%	5.55%	6.43%	5.43%	4.43%	I = H * C
Market to Asset Ratio (MAR)	1.61	1.44	1.35	1.3	1.44[17]	1.44	1.44	J
Notional Gearing	60%	60%	60%	60%	60%[18]	60%	60%	K
Equity Multiple	2.53	2.10	1.88	1.75	2.10	2.10	2.10	L = (J-K)/(1-K)
Real Cost of Equity	3.80%	3.50%	3.90%	3.20%	3.06%	3.59%	4.11%	M = I/L + C-I

16. The ENWL transaction based on Ofgem's model suggests a potential real cost of equity between 3.06% and 4.11%, depending on real RAV growth, suggesting that returns in this sector are already too high and the difference between baseline allowed return on equity and real cost of equity has grown since Ofgem produced this analysis for ED2. Iberdrola have also said they paid a 44% premium for ENWL[19] demonstrating that these companies are already highly attractive investments.

17. In May 2024 National Grid (NG) who own both Transmission and Distribution network companies in GB announced a £7billion Rights Issue (RI). They offered a 34.7% discount to the theoretical ex-rights price[20], within the average interval for UK companies[21]. The offer had a 91% acceptance rate[22], within the average range for the UK[23]. The RI was the largest one registered in the UK since 2009[24] and the issue was a part of NG's proposed investment strategy for the financial years of 2025 - 2029[25].

[17] Acquisition of Electricity North West, Iberdrola, August 2024
[18] RIIO-3 SSMD Allowed Return on Equity Early View Summary Calculations Ofgem, July 2024
[19] Acquisition of Electricity North West, Iberdrola, August 2024
[20] NG Announces Fully Underwritten £7bn Rights Issue, National Grid, 7 April 2024.
[21] Encouraging Equity Investment, Association of British Insurers, July 2013, page 36.
[22] Results of rights issue, London Stock Exchange, June 2024.
[23] RPC's Response to the UK Secondary Capital Raising Review Call for Evidence, November 2021, page 6
[24] Further Issues Summary, London Stock Exchange, 31 July 2024, accessed September 2024
[25] National Grid investment Proposition, National Grid, May 2024

18. This was a remarkably successful RI with investors purchasing additional shares despite not being associated with clear investments, timings or returns as well as taking place ahead of Ofgem's RIIO-3 methodology decision in July 2024. This strongly indicates that Ofgem's existing cost of equity methodology is already providing exceptional attractiveness to investors.

Implicit 'aiming up'

19. High cost of equity values are to be expected as we have previously presented evidence to the CMA about upward biases within the CAPM approach.

    a. Total Market Returns (TMR). Citizens Advice has consistently argued that TMR should represent all assets in the economy, rather than just UK equities. This includes within our submissions[26] to the CMA RIIO-2 Price Control appeal, which also provided evidence that indicated that long run (real) returns on all assets in the economy are likely to be appreciably lower than the corresponding long-run returns for equities. This is also unsurprising given that equities generally exhibit much greater systematic risk (i.e. correlation with macro-economic events) than all assets generally.

       This argument was accepted by the CMA[27]: *'...we agree with Citizens Advice's argument that, 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.'* The CMA acknowledges potential practical implementation issues, but says that regulators should give 'careful consideration'.

    b. Short-term betas. We have also stated concerns with giving weighting to shorter-term betas. This is primarily because index-investing has an upward bias on short-term betas. We explored this in our response to the UKRN consultation regarding cost of capital.[28] The UKRN decision

[26] Citizens Advice Intervention notice, April 2021
[27] Energy CMA 2021 appeals: Final Determinations Volume 2A, CMA, Para 5.200
[28] "Citizens Advice response to UKRN guidance" , November 2022. Page 13.

acknowledges this issue stating '*that more research is needed to quantify the size of this distortion*'[29].

20. Taken together the compromises made regarding TMR and equity betas mean the range for the cost of equity is structurally biased in favour of the companies and against the interests of consumers. We accept quantifying this bias is difficult; but it means that, when setting a spot estimate for the cost of equity, using the midpoint of the range, whilst making sense in theory, doesn't hold in reality. In the real world, it represents 'aiming up'. Explicitly aiming up on top of that, as Ofwat has done, is therefore highly likely to be generous.

21. We also believe the top of Ofgem's range for cost of equity to implicitly include 'aiming up'. This is due to the inclusion of European comparators for asset beta. The top half of the range (0.35-0.4) relies upon the inclusion of these European comparators. Indeed, the *only* comparators that support an asset beta at the top of Ofgem's range (0.4) are all from Italy, indicating that this is likely to be due to the Italian regulatory regime and so that they are not suitable as comparators.

[29] Guidance Consultation Issues and Taskforce Response, UKRN, March 2023

Fair bet

22. There are also arguments that a higher cost of equity should be allowed because the companies view that the price control is not a 'fair bet', a claim made by Northumbrian Water for example.[30] Evidence offered to support this includes current performance in PR19. Notwithstanding, as explained above, company performance needs to be re-evaluated to capture the inflation windfall, we note that Ofwat has made a number of changes addressing these issues[31]. For example:
    a. Increased protection for costs the companies have limited control over, including energy which had a significant impact in PR19.
    b. The introduction of an Outturn Adjustment Mechanism, specifically designed to mitigate against systematic out- or under- performance.
    c. Relaxing the benchmarking related to Outcomes from upper quartile to median.

23. There is a read-across to energy CMA 2021 appeals around Ofgem's decision to implement a 0.25% reduction in cost of equity based on the assumption of outperformance (known as the 'outperformance wedge'). On that occasion, the CMA found '*...GEMA has not demonstrated sufficiently why the extensive set of tools it used for RIIO-2 should be regarded as providing insufficient protection for customers*'[32]. Here, it has not been demonstrated why the actions that Ofwat has taken should be regarded as providing insufficient protection for companies.

24. Arguments that price control settlements are skewed against companies should also be viewed in the context of historical performance. 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. These advantages include an information asymmetry which is made worse by the amount of resources, including the use of consultants, that companies can make use of. Citizens Advice has previously published analysis[33] of the extent of excess returns companies have made as a result of these structural advantages.

[30] "Northumbrian Water statement of case", March 2025, Page 13.
[31] Summarised on slide 14 PR24 final determination City briefing
[32] Energy CMA 2021 appeals: Final determinations Volume 2B, CMA, Para 6.184
[33] Monopoly Money: How consumers overpaid by billions

Price control deliverables

25. We believe it is essential that consumers have confidence over what will be delivered for the funding provided through bills. We note some companies are seeking relaxation of PCDs around mains replacement to give the companies more flexibility around priorities.

26. Our experience in energy leads us to have concerns around this. In the review[34] conducted by CEPA for Ofgem regarding the effectiveness of the price control framework (RIIO), two of the areas identified by CEPA as adding returns for network companies in RIIO-1 were related to PCDs. These were:
    a. Allowances not being associated with outputs, generally allowing companies to keep a share of underspending not arising through efficient delivery.
    b. Setting PCD's for gas mains replacement based on risk removal, whilst allowances reflected costs related to replacing certain lengths of gas mains.

27. In practice, this second area led GDNs to optimise risk removal by prioritising cheaper interventions.This in turn led to higher allowances at the following price control (RIIO-2) as the GDNs sought funding for the more expensive interventions. This meant customers had to fund some of the more expensive interventions on two occasions - in RIIO-1 as these were part of the original cost assessment based on lengths of mains replacement, and then again in RIIO-2. On this occasion an efficient solution from the perspective of the companies was not an efficient solution for consumers.

28. This demonstrates adjusting PCDs can have unintended consequences which could, in turn, impact public trust if companies are not seen to be delivering on expectations.

[34] Review of the RIIO Framework and RIIO-1 performance, CEPA, March 2018

Updating data

29. Evidence is presented within the statements of case that simply including more recent data gives a different answer on a number of key parameters. We believe that these redeterminations should be done on the basis of the information that was available to Ofwat at the time of the decision.

30. The nature of these redeterminations is that only companies can refer to the CMA and, similar to energy, only the companies have effective appeal rights. If the precedent is set that results can be updated to include data after the original decision, it is reasonable to expect companies to go to the CMA when the new data give favourable results and not when the data is against them. This is likely to increase the number of appeals.

31. This cannot be good for consumers and would represent a shift in the balance between risk and reward that would need reflecting in the cost of equity.

Transparency

32. The statements of case refer to multiple consultant reports and extensive modelling. All third parties, including those representing consumer interests, do not have access to these. Whilst full access should be provided as a matter of course, Citizens Advice does not have the resources to engage with this volume of evidence. Assuming this is similar to other third parties, this risks a material imbalance in views provided to the CMA.

33. This is indicative of the general imbalance that exists between between the strength of the industry voice versus the consumer voice:
    a. *Commercial interest*. Government and consumer bodies have a common public interest in ensuring networks are able to support GB to meet legislative targets in an efficient way and with the right returns for investors (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.
    b. *Resource asymmetry*. Companies have a considerable commercial incentive to invest resources (time, personnel, consultancy fees) into the

regulatory process and have the financial ability to do so. Consumer advocates, on the other hand, are at a disadvantage with fewer financial and personnel resources to contribute to the process.

c. *Process asymmetry*. The process also needs to better recognise these asymmetries throughout the whole regulatory process and take actions to redress the balance.

34. Ofgem, for example, has acknowledged these issues, stating that the network price control process results overall with a balance of risk which favours the networks[35]. This therefore comes at increased cost and risk to consumers.

35. Whilst recognising the CMA has to operate within the rules as proscribed, it should consider any actions that can be taken to address these imbalances. For example, it could place restrictions on how much evidence can be provided by companies (including consultant reports) and make more of this evidence available to third parties. A number of the suggestions within the statements of case, such as the use of multi-factor models, are likely to make scrutiny by third parties harder which will ultimately be to the detriment of consumers. Whilst we have outlined above concerns with how the CAPM model is applied, this remains preferable to relying upon opaque and complex models. This would make the imbalance around the ability to present evidence between companies and groups representing consumer interests worse.

36. Another example is Ofgem's Network Asset Risk Metric ('NARM'). Whilst this is presented as an exemplar[36], it is, in practice, close to impenetrable to even well-informed third parties.

[35] Open letter: Future systems and network regulation, Ofgem, September 2022

[36] For example, Northumbrian Water suggests NARMs as a model Ofwat 'could be considering'