NON SENSITIVE

BEFORE THE COMPETITION AND MARKETS AUTHORITY
AN APPEAL UNDER SECTION 11A(1)(b) OF THE ELECTRICITY ACT 1989 AND SECTION 23B OF THE GAS ACT 1986

UTILITA ENERGY LIMITED

Appellant

-and-

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

UTILITA'S MAIN SUBMISSION

pursuant to Rule 5.2(a) of the
CMA Energy Licence Modification Appeals Rules

A. INTRODUCTION

1. This is the main submission of Utilita Energy Limited (**"Utilita"**) in support of its Notice of Appeal against the decision of the Gas and Electricity Markets Authority (the **"Authority"**) made on 26 July 2023 to modify standard licence conditions (**"SLC"**) 4B and 4D pursuant to s. 11A(1)(b) of the Electricity Act 1989 (**"EA89"**) (in respect of electricity supply licences) and s. 23(1)(b) of the Gas Act 1986 (**"GA86"**) (in respect of gas supply licences) (the **"Decision"**).

2. By the Decision, the Authority seeks to impose (among other things) minimum capital requirements on suppliers. This appeal is primarily concerned with the part of the Decision relating to a new **"Capital Target"**. The new Capital Target would require suppliers to retain a substantial amount of capital (£ 115 per customer) as a buffer to provide resilience against severe shocks. Suppliers which are unable to do so are required to submit to onerous terms which themselves make the raising of capital more difficult.

3. Utilita is a supplier of gas and electricity in the energy retail supply market and holds a licence to permit it to do the same. As set out below, and in the supporting evidence of William Bullen, Chief Executive Office ("**CEO**") of Utilita (**"Bullen 1"**) and the expert evidence of Dr Serena Hesmondhalgh, an independent expert economist at the Brattle Group (**"Hesmondhalgh 1"**), the Decision, if permitted to stand, will have very serious adverse consequences for Utilita, and for other challenger suppliers of gas and electricity in the retail energy market.

4. The holder of a relevant electricity or gas supply licence may apply to the CMA for permission to appeal under s. 11C(2)(a) EA89 and s. 23B(2)(a) GA86 respectively. Permission may be refused to such an appellant only on the grounds specified in subsection 4(d) of each section, namely (i) that *"the appeal is brought for reasons that are trivial or vexatious"*; or (ii) the appeal *"has no reasonable prospect of success"*.[1]

5. If permission is granted, the CMA must determine the appeal. The relevant grounds of appeal are set out in s. 11E(4) EA89 and s. 23D(4) GA86, which are materially identical. Those grounds are:

   5.1. The Authority failed to have regard to any matter to which it was required to have regard under s. 3A EA89 or s. 4A GA86;

   5.2. The Authority failed to give appropriate weight to any matter to which it was required to have regard under s. 3A EA89 or s. 4A GA86;

   5.3. The Authority's decision was based on an error of fact;

   5.4. The modifications fail to achieve, in whole or in part, the effect stated by the Authority; and

   5.5. The decision was wrong in law.

6. The CMA has explained that *"the key question is whether GEMA made a decision that was wrong (on one of the prescribed statutory grounds)"*, and to that extent, the merits of the decision are to be taken into account.[2] The CMA will not *"uncritically accept GEMA's*

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1 Gas Act 1968, s.23B(4)(d)(i) & (ii) **[NOA1/953]**, Electricity Act, s.11C(4)(d)(i) & (ii) **[NOA1/1012]**

2 *Cadent Gas v GEMA*, 28 October 2021 §3.31 **[NOA1/1118]** Those appeals concerned a challenge against the Authority's decision for the electricity transmission, gas transmission and gas distribution network companies, modifying the conditions of their respective licences to give effect to the RIIO-2 price control Final Determinations.

assessment and weighting of the considerations before it".[3] In particular, a decision will be *"wrong"* where (non-exhaustively):

6.1. There is a reasonable alternative course which *"clearly had greater merit than the solution chosen by GEMA"* (a matter which would reflect on the *"inherent merits"* of the Authority's chosen solution).[4]

6.2. The decision is *"based on unreliable data or fails to take account of the relevant evidence"*.[5]

6.3. The decision is *"based on a plain error of fact or is wrong in law"* (in which case, there would be *"no room for a margin of appreciation"*).[6]

7. Accordingly, the CMA's appeal powers, while not involving a full rehearing/remaking of the decision, involve the CMA grappling with the merits of the decision which the Authority made (in contrast to, for example, judicial review proceedings).

8. Utilita's case on appeal is that the Decision in relation to the Capital Target is neither appropriate to its objective nor proportionate; will reduce rather than foster competition thus favouring the remaining **"Big Six"** legacy suppliers;[7] and will lead to adverse outcomes for consumers. Utilita therefore submits that the Authority's Decision was wrong on the following grounds (as further particularised in the relevant sections below):

8.1. **Ground 1:** The Authority erred in concluding that the Capital Target would further the objective it was intended to achieve.

8.2. **Ground 2:** The Authority erred in calculating the level at which the Capital Target ought to be set.

8.3. **Ground 3:** The Capital Target (at any level, and certainly at the designated level) is unnecessary and disproportionate.

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[3] Ibid. §3.78. **[NOA1/1126]**
[4] Ibid. §3.43. **[NOA1/1121]**
[5] Ibid. §3.47. **[NOA1/1122]**
[6] Ibid. §3.72. **[NOA1/1124]**
[7] British Gas, EDF Energy, E.ON, npower, Scottish Power and SSE, which rose to dominance following privatisation. See further **Bullen 1 §§2.2-2.18**. These suppliers are vertically integrated, including in some cases with infrastructure, which leads to a greater level of resource, as well as greater access to parent company finance or guarantees.

9. Utilita therefore respectfully asks the CMA to quash the Decision insofar as it imposes the Capital Target.

B. BACKGROUND FACTS

(1) Utilita

10. As explained in **Bullen 1 §2.2**, Utilita has operated in the energy retail supply market since 2004.[8] The role of Utilita, in common with other suppliers, is to sell electricity and gas to end users. Such end-users can be domestic or non-domestic customers (including micro-businesses and industrial and commercial customers).

11. Utilita was the first *"pay as you go"* smart prepayment energy supplier and remains one of a very small number of predominantly prepayment meter-led suppliers. It has been installing smart prepayment meters since 2008.[9] All of Utilita's prepayment customers are on variable tariffs,[10] whilst Utilita's business customers are on fixed tariffs. Utilita predominantly supplies energy to domestic customers.

12. Energy supply through smart prepayment meters has been an important innovation in the market which has allowed Utilita to deliver lower prices for its customers by keeping costs low. As explained in **Bullen 1 §3.6**:

> *"Smart prepayment meters allow Utilita to offer customers energy credit facilities, in order to prevent customers from going off supply as a result of non-payment. I will describe these facilities in more detail in the next section of my statement.[11] If customers do go off supply, with smart prepayment meters they can be reconnected easily and remotely, whereas traditional prepay meters had to be reconnected in person by technicians (with attendant time and costs). As such, smart prepayment meters have allowed Utilita to operate at a lower cost than a traditional prepayment supplier and*

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[8] Although Utilita exited the supply market in 2006 following the 2005 gas crisis, it re-entered in 2007.
[9] Prepayment meters are a type of domestic energy meter that requires users to pay for energy before using it, effectively allowing customers to 'pay as they go' for gas or electricity. Customers can top up their meters whenever they choose and by as much as they like.
[10] Whereby the unit rates and standing charges can be increased or decreased by Utilita depending on the cost of energy, as opposed to a fixed tariff, where the unit rates and standing charges are fixed for a certain period of time.
[11] See paragraphs 3.12 – 3.17 below.

Utilita has been able to pass concomitant savings (and the other more practical smart meter benefits, such as being able to top up online rather than having to do so in person) on to its customers".

13. Utilita has approximately ✄ customers. A large proportion of its customers are considered to be vulnerable.[12] As such, Utilita provides a service to many low-income customers, for whom a prepayment meter is often the preferred choice for energy supply, since expenditure on energy can thereby be limited to what is actually needed and on a 'pay-as-you-go' basis, which is often more manageable for that customer than alternatives. These important advantages of the responsible use of prepayment meters have been recognised by the Authority.[13] Utilita makes provision for issues that might arise for lower income customers as regards interruption to supply (and trying to avoid this) by providing free periods of power where it will not be disconnected and some circumscribed basic 'loan' facilities.[14]

14. In short, Utilita considers (and the Authority appears to agree) that its business model is a valuable addition to the industry, which serves its (often vulnerable) customers well. However, as set out below, the Decision has the potential to make such business models unsustainable.

15. There are three key elements to Utilita's business model:

    15.1. **First**, Utilita has a relatively strong cash flow with limited risk of customers failing to pay for their energy. This is because it is focused on the prepay market, in comparison to the more traditional 'pay on receipt of bill' model (including by direct debit) employed by the majority of its competitors. The facilities available to customers at risk of disconnection mean that Utilita's financial exposure to non-payment is limited. By contrast, if Utilita were focussed on the traditional model, it would be exposed to a greater risk of customers defaulting on their bills and consequent cashflow fluctuations.

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[12] According to its customer services register, ✄ of Utilita's customers have declared themselves as vulnerable (see **Bullen 1 §3.10**).

[13] Letter from Ofgem re: Prepayment meter rules and protections for domestic consumers: a call for evidence dated 21 February 2023[**NOA1/475**].

[14] See **Bullen 1 §§3.11-3.17.**

15.2. **Second**, Utilita is able to minimise its exposure to price fluctuations. It only offers a standard variable tariff to its domestic customers and so can modify the prices it charges for supplying energy in line with the wholesale cost (subject to the constraints of the statutory price cap). By contrast, if Utilita was to start offering fixed price tariffs instead of variable tariffs, it would need to adopt a rather different hedging strategy (as it would be much more at risk of price fluctuations in the energy market) and/or to retain more capital to offset the longer-term risk on price that it would face.

15.3. **Third**, Utilita is able to hedge its risk through a power supply agreement with its trading partner, British Gas Marketing Limited ("**BP**").[15] ✂. This limits Utilita's vulnerability to wholesale energy price changes and allows it to adapt its strategy in a fluctuating market.[16] ✂.

16. Accordingly, Utilita and companies like it require less capital and/or liquidity to operate resiliently than more traditional competitors which do not share their attributes. Utilita's business model – and associated capital levels - have allowed Utilita to continue to operate successfully during the recent energy crisis, one of the most challenging periods the supply market has ever seen.

17. Further, Utilita has limited options to raise further equity or debt finance. In particular:

17.1. Utilita cannot accumulate significant capital through retained profits, not least because its profitability is constrained by the price cap.

17.2. Utilita cannot obtain equity investment on terms which would not negatively affect its business. As a small challenger supplier operating in a price-capped market which has seen recent large-scale supplier failure and an ongoing energy crisis, Utilita's shares would have to be offered at very low prices in order to attract investment. As **Bullen 1 §3.31** explains, this is especially so where, under the tariff differential approach, the Authority sets the cap at a level below what it considers to be the "*cost reflective*" level.

[15] Utilita currently benefits from its relationship with BP, ✂.

[16] As part of the hedging process, Utilita takes into consideration the estimated amount of energy that it will deliver in a future quarter, on the basis of seasonal norms for temperature and usage of energy. There is also an assumed percentage of customer growth added to this estimate.

17.3. As regards obtaining commercial debt funding, the type of debt which Ofgem will permit to count towards the capital target is very unlikely to be commercially available – it must be unsecured and capable of being called down in insolvency. The Authority appears to accept that this is not a realistic source of capital for the purposes of meeting the target – it agrees that *"there aren't currently many instruments available in the market for independent suppliers"*[17].

18. The upshot of these points is that Utilita, and suppliers like it, (a) need less reserve capital to operate resiliently; but (b) cannot readily raise more capital than they need.

19. For the reasons set out below, the Capital Target puts fundamentally resilient suppliers operating under those conditions in an unsustainable position, for minimal (if any) regulatory benefit.

(2) Background to the Decision

20. In the recent energy crisis, there was a series of failures of energy suppliers. A *"Review of Ofgem's regulation of the energy supply market"* prepared by Oxera (the **"Oxera Report"**[18]) identified one cause of these failures as being the business models adopted by certain challenger suppliers, and in particular identified the *"growth model"* (under which suppliers relied on receiving customer balances before delivering services and used these prepayments to fund the ongoing costs of the business); and the *"timing model"* (under which suppliers undercut hedged rivals by entering the market at favourable moments and concluding long-term supply agreements with customers based on prevailing low spot rates). Oxera concluded:

> *Consistent with our understanding of supplier business models, we have identified that a number of suppliers that would go on to fail shared many of the following financial and operational characteristics: (i) negative equity balances in the years leading up to their failure; (ii) poor liquidity (current ratios and low levels of working capital); (iii) over-reliance on their customer credit balances to finance their operations; and (iv) either unhedged, or not substantively (i.e. more than 50% over nine months or more) hedged, positions.*[19]

[17] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirements and Ringfencing CCBs by Direction dated 26 July 2023, §2.22 [**NOA1/706**]
[18] Review of Ofgem's regulation of the energy supply market dated 3 May 2022, [**NOA1/104**]
[19] Ibid. [**NOA1/114**]

21. This finding related to the suppliers which failed. It did not, of course, relate to the whole energy market, or to all challenger suppliers. In particular these characteristics emphatically do not apply to Utilita, which was able to weather the energy crisis, notwithstanding its low-capital business model serving low-income consumers.

(3) <u>Action Plan and Consultation</u>

(a) <u>The Action Plan</u>

22. In December 2021, the Authority announced an Action Plan on retail financial resilience with the objective *"to create a market where energy suppliers are financially resilient, so that risks are not inappropriately passed to consumers"*[20]. One part of the Action Plan was to impose *"robust minimum standards"*, one example of which was that *"suppliers need to be adequately hedged <u>or</u> hold sufficient capital to manage a wide range of market scenarios"*[21].

23. In an update to the Action Plan dated 14 April 2022, the Authority stated:

> *Suppliers without sufficient capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure. And under present market conditions, the significant costs of failures borne by customers have far exceeded the cost of refunding the credit balances and RO payments of individual suppliers. As such, this moral hazard can give rise to very poor outcomes for consumers and systemic risks to the retail supply market, even in circumstances where the majority of suppliers do not rely on such unsustainable business models.*[22]

(b) <u>The June 2022 Consultation</u>

24. The Authority launched a policy consultation regarding proposals to strengthen financial resilience in the retail energy market (including proposed minimum capital requirements) on 20 June 2022 (the **"June 2022 Consultation"**). In the June 2022 Consultation, the Authority stated that it wanted *"an energy supply market where energy suppliers are financially resilient, and where suppliers bear the appropriate cost of risk-taking so that costs are not inappropriately passed on to consumers"* and that *"[s]uppliers should have*

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[20] Action plan on retail financial resilience dated 15 December 2021 [**NOA1/80**]
[21] Ibid. [**NOA1/80**] Underlining added.
[22] Update to December Action Plan: Customer Credit Balances and Renewables Obligation protection dated 14 April 2022 [**NOA1/96**]

sufficient capital and sustainable business models to ensure they are sufficiently resilient to market shocks"[23]. The Authority sought views on proposals to improve retail supplier financial resilience, including: (1) ringfencing money collected to meet renewable obligation (**"RO"**) payments; (2) capital adequacy requirements for suppliers; and (3) ringfencing consumer credit balances (**"CCBs"**).

25. In respect of capital adequacy requirements for suppliers, the Authority stated that its *"emerging thinking is that suppliers should be expected to maintain a minimum capital buffer, with the possibility of additional, bespoke capital requirements for higher risk suppliers"*[24]. The Authority identified two suggested beneficial incentive properties of such a proposal [25]: (1) that investors having *"skin in the game"* would reduce moral hazard; and (2) that raising capital would incentivise scrutiny and due diligence of a firm's business plans. It noted that *"<u>all</u>[26] failed suppliers had negative equity balances at the end of FY2020, and that overall, supplier failure is clearly associated with persistent negative equity balances"*[27].

26. The Authority suggested that supplier resilience ought to mitigate the following risks: (1) price risk; (2) churn/volume/demand risk; (3) counterparty credit risk; (4) liquidity risk; (5) other market risks; (6) credit risk; (7) operational risk; and (8) systemic risk[28].

27. The Authority suggested that whilst increasing capital adequacy requirements would result in an initial *additional* cost associated with raising capital, which would ultimately be passed on to consumers, in the long run it expected financial resilience measures to result in *lower* costs of capital overall for suppliers due to better creditworthiness: *"Therefore we expect that the wider benefits of increased financial resilience, which are likely to include fewer failures and associated mutualisation costs and therefore overall a more resilient market with greater competition and investibility, would outweigh those increased costs."*[29]. The Authority summarised its assessment of the trade-offs in Table 3[30]:

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[23] Ofgem Policy Consultation – Strengthening Financial Resilience dated 20 June 2022, §1.2 [**NOA1/126**]
[24]Ibid. [**NOA1/122**]
[25] Ibid, §1.10 [**NOA1/130**]
[26] Underlining added.
[27] Ibid. §6.8 [**NOA1/190**]
[28] Ibid. §6.35 [**NOA1/198-200**]
[29] Ibid. §6.13 [**NOA1/193**]
[30] Ibid. §6.43, Table 3: Overall trade-offs [**NOA1/202**]

	Costs	Benefits
Supplier trade-off	Initial cost of raising required capital or more thoroughly hedging	Benefit of lower cost of capital and collateral due to reduced probability of default
Consumer trade-off	Increased costs associated with tariffs that are hedged or capitalised against	Reduced costs associated with lower failure rates and consequential consumer switching
Market trade-off	Higher entry/growth bar	More sustainable business models which ultimately contribute to greater investibility, supporting greater competition and innovation in the market

28. As to how *"capital"* for the purpose of a regulatory framework should be defined, the Authority stated that the main focus should be on *"going-concern capital"*[31]. It stated: *"Generally speaking, going concern capital is that which can immediately and reliably absorb unexpected losses. That means it usually is limited to those instruments which are high quality and reliably available to be able to absorb losses even in a situation where market conditions might be deteriorating. Principally, this traditionally is equity, which can be more expensive"*[32].

29. Importantly, the Authority acknowledged that:

29.1. At §1.13[33], *"Development of our proposals will be aligned with our work on the appropriate level of return under the price cap, and will need to strike an appropriate balance between resilience and competition/innovation, to optimise outcomes for consumers."* (and see §§6.16 – 6.21[34]).

29.2. At §1.16[35], *"it is important that Ofgem does not reactively swing from one end of the competition-resilience spectrum to the other"* and that the regime must be designed to *"enable a sustainable, innovative, and competitive market"*.

29.3. At §6.12[36], *"[o]ur intention is not to eliminate entirely the possibility of supplier failure, but rather to better align supplier incentives with more sustainable business models that can withstand reasonable stress"*.

29.4. Its minded to position was that a capital adequacy regime would need to have some element of risk sensitivity (§6.26[37]) and supplier segmentation

[31] Ibid. §6.45 [**NOA1/203**]
[32] Ibid. §6.46 [**NOA1/203**]
[33] Ibid. §1.13 [**NOA1/132**]
[34] Ibid. §6.16-6.21 [**NOA1/194-195**]
[35] Ibid. §1.13 [**NOA1/133**]
[36] Ibid. §6.12 [**NOA1/193**]
[37] Ibid. §6.26 [**NOA1/196**]

(§6.30[38]) and that *"[t]he majority of suppliers we have engaged with also have supported a risk-based framework despite some added complexity, compared to more blunt 'one-size-fits-all' approaches"* (§6.31[39]). Similarly, at §6.40[40], the Authority stated: *"we consider that a segmented approach may be most efficient, where expectations are proportionate to the size and importance of a business to the market."*

29.5. At p. 94: *"In developing this policy we will need to have regard to licensee financeability. The regulation of the retail market is evolving alongside this policy development and we plan to particularly align the development of this and price cap return reforms."*[41]

30. The Authority explained that its suggested approach to capital adequacy was to implement a *"Pillar 1 and Pillar 2"* scheme[42]:

30.1. Pillar 1 would require all suppliers to maintain a minimum regulatory capital buffer, specified by the Authority by reference to the minimum amount of capital needed for a well-hedged supplier to endure a certain level of unexpected shock and remain solvent.

30.2. Pillar 2 would be an additional bespoke capital buffer: *"Ofgem will consider the holistic picture of a supplier's financial resilience in practice to determine what additional actions are needed – including possible additional capital – to meet a target resilience level."*[43]

31. Chapter 7 of the June 2022 Consultation set out the Authority's assessment of costs and benefits, drawing on a report produced by NERA. In particular, the Authority concluded:

> *We believe that these proposals, alongside other measures, are likely to enable a more sustainable competitive market that should be beneficial to consumers over time through increased market stability and a better environment for innovation to take place. On the other hand, we recognise that these proposals could affect suppliers' entry and/or expansion, and could even lead to exit. However, we believe that it is beneficial to consumers to limit the opportunities for inefficient expansion or entry.*[44]

[38] Ibid. §6.30 [**NOA1/197**]
[39] Ibid. §6.31 [**NOA1/197**]
[40] Ibid. §6.40 [**NOA1/201**]
[41] Ibid. [**NOA1/209**]
[42] Ibid. §6.57, Table 6: Approaches and monitoring/enforcement [**NOA1/206**]
[43] Ibid. [**NOA1/206**]
[44]Ibid. §7.26 [**NOA1/217**]

32. It was also noted that the proposals *"could increase costs for small suppliers relative to large legacy suppliers as they don't necessarily have access to capital at the same cost of capital in order to replace the CCBs and RO they would otherwise have access to. As a result, this could lead to lower competitiveness of small suppliers."*[45].

(c) The November 2022 Consultation

33. On 25 November 2022, the Authority issued a statutory consultation entitled "*Statutory Consultation: Strengthening Financial Resilience*" (the "**November 2022 Consultation**") setting out its revised proposals, in light of feedback from the June 2022 Consultation[46]. Together with its consultation the Authority supplied a draft of the new SLCs it was proposing to implement. The November 2022 Consultation was accompanied by a "*Revised Impact Assessment of Strengthening Financial Resilience proposals*" (the "**Impact Assessment**")[47].

34. The Authority confirmed its proposals that *"suppliers should be required to hold an amount of capital closely informed by what they are compensated for under the price cap return"* (§3.16[48]). It stated that *"the minimum capital requirement is not intended to represent the right answer for the amount of capital or liquidity specific suppliers need to hold against their own business risks. It is a Pillar 1 minimum amount based on a notional supplier…"* (§3.19[49]).

35. Importantly, the Authority now suggests that the minimum capital requirement would relate to only *some* of the risks summarised at paragraph 26 above, in particular, *"wholesale price volatility and unexpected demand shock"* (§3.23[50]).

36. In respect of the market-wide capital requirement, the Authority explained that this *"ultimately will be closely informed by the level of 'capital employed' on which suppliers receive a return under the EBIT allowance. In this consultation, we propose setting a shorter-term target for domestic suppliers to have £110-220 per domestic customer of net assets by the end of March*

[45] Ibid. §7.32 [**NOA1/218-219**]
[46] Statutory Consultation: Strengthening Financial Resilience dated 25 November 2022 [**NOA1/238**]
[47] Revised Impact Assessment of Strengthening Financial Resilience proposals dated 25 November 2022 [**NOA1/341**]
[48] Statutory Consultation: Strengthening Financial Resilience dated 25 November 2022, §3.16 [**NOA1/288**]
[49] Ibid.
[50] Ibid. §3.23 [**NOA1/290**]

2025, with suppliers required to submit transition plans showing clear 'staging posts' or increments for how they intend to reach that target."[51]

(d) <u>*The 5 April 2023 Decision*</u>

37. On 5 April 2023, the Authority published a decision document entitled *"Decision on Strengthening Financial Resilience"* (the **"5 April 2023 Decision"**)[52]. This document explained the Authority decisions; (a) to establish the enhanced Financial Responsibility Principle and (b) to create a market-wide obligation to ringfence RO receipts attributable to domestic supply.

38. However, the Authority decided not at that stage to implement a common minimum capital requirement for suppliers or require ringfencing of CCBs but instead to consult further on those issues.

39. The enhanced Financial Responsibility Principle imposed various positive obligations on all electricity and gas suppliers (by virtue of amendments to SLCs), including:

    39.1. SLC 4B.1: Supply licensees must ensure that they *"maintain Capital and Liquidity of sufficient amount and Quality that it is able to meet its reasonably anticipated financial liabilities as they fall due on an ongoing basis."*[53] and

    39.2. SLC 4B.2: Each supply licensee must ensure that, if it were to the exit the market for any reason, *"its operational and financial arrangements are such that any Supplier of Last Resort or special administrator appointed would be able to efficiently and effectively serve its customers and that the exit would result in minimised Mutualised costs."*[54]

40. The 5 April 2023 Decision was effective from 31 May 2023.

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[51] Ibid. §1.34 [**NOA1/267**]
[52] Ofgem Decision on Strengthening Financial Resilience dated 5 April 2023 [**NOA1/500**]
[53] Modification of the standard conditions of all gas supply licenses [**NOA1/630**], Modification of the standard conditions of all electricity supply licenses [**NOA/641**]
[54] Ibid.

(e) *Further Consultation*

41. The 5 April 2023 Decision was published along with a further statutory consultation on the proposed minimum capital requirements to *"clarify our proposals and refine the policy design and licence drafting"* (the **"April 2023 Consultation"**)[55].

42. This further consultation stated that the Authority *"remain convinced that it is in the consumer interest for retail energy companies to have more capital to be sufficiently resilient to future shocks"*, but that *"recognising the diversity of business models in the current market, Ofgem's duty to give regard to supplier financeability and Ofgem's continued objective to protect competition we think there is a strong case for building some flexibility into the minimum capital requirement mechanism"* [56]. The Authority described the Capital Target Level as *"a loss-absorbing buffer for all firms in times of stress"*[57].

43. As to the interaction of the Capital Target and the price cap, the Authority said this:

> *…to arrive at a representative figure for the EBIT allowance, the price cap necessarily relies on the construct of a single, notional efficient supplier. The Capital Target applies to all domestic suppliers at all times, and so must be robust to a range of different business models and take into account the plausible means by which a supplier may de-risk their business, including alternative forms of capital.*
>
> *Finally, the price cap implies an average level of capital employed by this notionally efficient supplier. In practice, the level of capital for this notional supplier – as for real suppliers – may fluctuate throughout the year. Our capital target applies throughout the year, and so must be set at a level below this average.* [58]

(4) **The Decision**

44. The Authority published the Decision on 26 July 2023[59]. By the Decision, the Authority has decided to impose a Capital Target in a similar form to that proposed in the April 2023 Consultation. In particular Decision involves the following new provisions:

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[55] Further Statutory Consultation: Strengthening Financial Resilience – introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction, [**NOA1/569**]
[56] Ibid. §1.9 [**NOA1/584**]
[57] Ibid. §3.14 [**NOA1/602**]
[58] Ibid. §3.30-3.31 [**NOA1/606**]
[59] Strengthening Financial Resilience- Minimum Capital Requirement and Ringfencing CCBs by Direction [**NOA1/672**]

44.1. SLC 4B.16 provides that a licensee's Adjusted Net Assets must not be below the **"Capital Floor"**[60].

44.2. SLC 4B.18 imposes obligations on suppliers in the **"Intermediate Position"** (i.e., between the Capital Floor and Capital Target). Such suppliers must notify the Authority and adhere to the **"Transition Controls"**[61].

44.3. SLC 4B.19 governs the use of **"Alternative Sources of Capital"**, and in particular, requires the Authority to be notified of and approve the use of Alternative Sources of Capital[62]. The available alternative sources are (in summary) unsecured loans meeting certain requirements, a documented and unsecured loan failure from a parent entity, and unconditional guarantees from a parent entity.

44.4. SLC 4B.20 requires a licensee in the Intermediate Position to submit a Capitalisation Plan for the Authority's approval, defined as a *"credible plan submitted by the licensee and accepted by the Authority"*[63]. The Capitalisation Plan must set out (among other things): the cause of the licensee being below the Capital Target, the level of funds needed to meet the Capital Target; how those funds are to be raised; and how existing funds are to be conserved (including by refraining from non-essential payments).

44.5. SLC 4B.21 – 22 govern amendments to the Capitalisation Plan[64].

45. This appeal concerns the decision to impose the Capital Target, and the associated compliance framework should a supplier fail to meet it.

C. LEGAL FRAMEWORK

(1) <u>Power to vary SLCs</u>

[60] Ibid. [**NOA1/688**]
[61] Ibid. [**NOA1/716**]
[62] Ibid. [**NOA1/713**]
[63] Ibid. [**NOA1/721**]
[64] Ibid. [**NOA1/720**]

46. The Authority is empowered to promulgate SLCs for a licence of a supplier of gas and electricity pursuant to s. 8 GA86 and s. 8A EA89.

47. Pursuant to s. 11A EA89 (and the materially similar provisions of s. 23 GA86):

> *(1) The Authority may make modifications of—*
>
> *(a) the conditions of a particular licence;*
>
> *(b) the standard conditions of licences of any type mentioned in section 6(1).*
>
> *(2) Before making any modifications under this section, the Authority must give notice—*
>
> *(a) stating that it proposes to make modifications;*
>
> *(b) setting out the proposed modifications and their effect;*
>
> *(c) stating the reasons why it proposes to make the modifications; and*
>
> *(d) specifying the time within which representations with respect to the proposed modifications may be made*
>
> *[…]*
>
> *(7) The Authority must—*
>
> *(a) publish the decision and the modifications in such manner as it considers appropriate for the purpose of bringing them to the attention of persons likely to be affected by the making of the modifications,*
>
> *(b) state the effect of the modifications,*
>
> *(c) state how it has taken account of any representations duly made, and*
>
> *(d) state the reason for any differences between the modifications and those set out in the notice by virtue of subsection (2)(b).*[65]

(2) <u>The Authority's Statutory Duties</u>

48. Pursuant to s. 3A EA89/s. 4AA GA86 (emphasis added):

> *"(1) The principal objective […] is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems [or gas conveyed through pipes].*
>
> *(1A) Those interests of existing and future consumers are their interests taken as a whole, including—*
>
> *(a) their interests in the reduction of electricity-supply [or gas-supply] emissions of targeted greenhouse gases;*

[65] Electricity Act 1989, s.11A [**NOA1/1007-1008**]

(b) their interests in the security of the supply of electricity [or gas] to them; and

(c) their interests in the fulfilment by the Authority, when carrying out its designated regulatory functions, of the designated regulatory objectives.

(1B) The Secretary of State and the Authority ***shall*** *carry out their respective functions under this Part in the manner which the Secretary of State or the Authority (as the case may be) considers is best calculated to further the principal objective,* ***wherever appropriate by promoting effective competition*** *between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors [or the shipping, transportation or supply of gas conveyed through pipes].*

(1C) Before deciding to carry out functions under this Part in a particular manner with a view to promoting competition as mentioned in subsection (1B), the Secretary of State or the Authority ***shall*** *consider—*

(a) ***to what extent the interests referred to in subsection (1) of consumers would be protected by that manner of carrying out those functions****; and*

(b) ***whether there is any other manner (whether or not it would promote competition as mentioned in subsection (1B)) in which the Secretary of State or the Authority (as the case may be) could carry out those functions which would better protect those interests****.*

(2) In performing the duties under subsections (1B) and (1C), the Secretary of State or the Authority ***shall*** *have regard to —*

(a) the need to secure that all reasonable demands for electricity [or gas conveyed through pipes] are met; and

(b) ***the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part****, the Utilities Act 2000, Part 2 or 3 of the Energy Act 2004, Part 2 or 5 of the Energy Act 2008 or section 4, Part 2, sections 26 to 29 of the Energy Act 2010 or Part 2 of the Energy Act 2013; and*

(c) the need to contribute to the achievement of sustainable development.

(3) In performing the duties under subsections (1B), (1C) and (2), the Secretary of State or the Authority ***shall*** *have regard to the interests of—*

(a) individuals who are disabled or chronically sick;

(b) ***individuals of pensionable age****;*

(c) ***individuals with low incomes****; and*

(d) individuals residing in rural areas;

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

[…]

(5) Subject to subsections (1B) and (2), and to section 132(2) of the Energy Act 2013 (duty to carry out functions in manner best calculated to further delivery of policy

outcomes) the Secretary of State and the Authority ***shall*** *carry out their respective functions under this Part in the manner which he or it considers is best calculated –*

(a) ***to promote efficiency and economy on the part of persons authorised by licences*** *or exemptions to distribute, supply or participate in the transmission of electricity, to participate in the operation of electricity interconnectors or to provide a smart meter communication service and the efficient use of electricity conveyed by distribution systems or transmission systems [or to carry on any activity, and the efficient use of gas conveyed through pipes];*

(b) to protect the public from dangers arising from the generation, transmission, distribution or supply of electricity [or the conveyance of has through pipes or from the use of gas conveyed through pipes] or the provision of a smart meter communication service;

(ba). . . . .

(c) to secure a diverse and viable long-term energy supply,

and shall, in carrying out those functions, have regard to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity [or the conveyance of gas through pipes] or the provision of a smart meter communication service.

(5A) In carrying out their respective functions under this Part in accordance with the preceding provisions of this section the Secretary of State and the Authority ***must*** *each have regard to –*

(a) ***the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed****; and*

(b) any other principles appearing to him or, as the case may be, it to represent the best regulatory practice.

(5B) In subsection (1A) –

"the designated regulatory objectives" means the objectives set out in Article 36(c) to (h) of the Electricity Directive [or Article 40(c) to (h) of the Gas Directive] but read with the following modifications –

(a) in Article 36(c) [or Article 40(c)], for the words from "between" to the end substitute ", including enabling the development of appropriate cross-border transmission capacities to meet demand; "

(b) in Article 36(d) [or Article 40(d)], omit ", in line with general energy policy objectives,

(c) in Article 36(f) [or Article 40(f)], omit "and foster market integration", and

(d) in Article 36(g) [or Article 40(g)], for "their national market" substitute " the energy market in Great Britain ";

[…]

(6) In subsections (1C), (3) and (4) references to consumers include both existing and future consumers."[66]

49. By s. 64(1) EA89, the *"Electricity Directive"* is defined as Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity. By s. 48(1) GA86, the *"Gas Directive"* is defined as Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas.

50. The relevant parts of Article 36 of the Electricity Directive and Article 40 of the Gas Directive define the general objectives of the regulatory authority as follows (emphasis added):

(c) eliminating restrictions on trade in electricity [or natural gas] between Member States, including developing appropriate cross-border transmission capacities to meet demand and enhancing the integration of national markets which may facilitate electricity flows [or natural gas flow] across the Community;

(d) ***helping to achieve, in the most cost-effective way, the development of secure, reliable and efficient non-discriminatory systems that are consumer oriented, and promoting system adequacy*** *and, in line with general energy policy objectives, energy efficiency as well as the integration of large and small-scale production of electricity [or gas] from renewable energy sources and distributed generation [or production] in both transmission and distribution networks;*

(e) facilitating access to the network for new generation [or production] capacity, in particular ***removing barriers that could prevent access for new market entrants*** *and of electricity [or gas] from renewable energy sources;*

(f) ***ensuring that system operators and system users are granted appropriate incentives, in both the short and the long term, to increase efficiencies in system performance and foster market integration;***

(g) ***ensuring that customers benefit through the efficient functioning of their national market, promoting effective competition and helping to ensure consumer protection;***

(h) ***helping to achieve high standards of universal and public service in electricity supply [or for natural gas], contributing to the protection of vulnerable customers and contributing to the compatibility of necessary data exchange processes for customer switching****.*

51. Proportionality (as referred to in subsection 5A above) requires (i) that the objective sought to be achieved is sufficiently important to warrant intervention; (ii) that the measures designed to achieve an objective are rationally connected to it, (iii) that the intervention goes no further than is necessary to achieve the objective and (iv) that the

[66] Electricity Act 1989, s.3A [**NOA1/965-971**], Gas Act 1986 s. 4AA [**NOA1/894-898**]

intervention strikes a fair balance between the needs of the individual and the interests of wider society: see for example *Huang v Secretary of State for Home Department* [2007] UKHL 11, [2007] 2 A.C. 167 §19.[67]

D. GROUNDS OF APPEAL

(1) <u>Ground 1: The Capital Target does not Achieve the Effect Stated by the Authority</u>

52. The Capital Target will not achieve the effect which the Authority has stated it seeks to achieve.[68] In that regard, the Authority's decision is *"wrong"*. It fails to take into account relevant evidence, or the absence thereof;[69] and is a clearly inferior approach compared to the adoption of the Authority's other resilience measures *without* an accompanying Capital Target (and thus the Authority has failed to have regard, or to give appropriate weight, to the applicable mandatory considerations[70]).

53. The Authority is required by s. 11A(7)(b) EA89 and s. 23(7)(b) to *"state the effect of the modifications"* which it has made. The stated effect of the amendment to SLC 4B (which gives effect, *inter alia*, to the Capital Target) is to *"help deliver a retail energy market that is secure, sustainable, and therefore able to deliver the innovation and positive consumer outcomes needed in the future"*, in order to *"address some of the systemic challenges in the retail energy market that led to high levels of supplier failure and high mutualised costs for consumers"* [71]. The Authority considers that a Capital Target will help reduce failures and the risk of mutualising costs of failures to consumers, both directly by providing a capital buffer that reduces insolvency risk, and indirectly, by producing incentives for better monitoring of risks.

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[67] [**NOA1/1039**]
[68] And thus the appeal should be allowed in accordance with s. 11E EA89 and s. 23D GA86, subsection (4)(d).
[69] Contrary to ordinary principles of public law, in particular, the requirements to take into account relevant considerations and act rationally, and thus the appeal should be allowed in accordance with s. 11E EA89 and s. 23D GA86, subsection (4)(e). Further and/or alternatively, Utilita also relies on the ground of appeal in s. 11E EA89 and s. 23D GA86, subsection (4)(c), that *"the decision was based, wholly or partly, on an error of fact"*.
[70] And thus the appeal should be allowed in accordance with s. 11E EA89 and s. 23D GA86, subsections (4)(a) and (4)(b).
[71] Modification of the standard conditions of all gas supply licenses [**NOA1/753**], Modification of the standard conditions of all electricity supply licenses [**NOA/740**]

54. However, the imposition of the Capital Target as set out in the Decision will not achieve this, for the following reasons.

55. **First**, an energy market with a Capital Target would not face materially lower levels of supplier failure and mutualised cost than one without one. The high levels of supplier failure and mutualised cost were caused by suppliers which fell below the Capital Floor. There is *no evidence* that a Capital Target would have made any difference at all in the recent crisis and no sound, lawful, underpinning for regulatory intervention on the basis of an assumption to the contrary on the part of the Authority:

55.1. As a matter of what in fact happened during the crisis, no supplier in the *"Intermediate Position"* failed, despite the industry facing one of the worst energy crises in living memory. There is, simply, no evidence that what in fact happened would have been prevented or ameliorated by the Capital Target.

55.2. Indeed, importantly, the Authority itself concludes that *"all failed suppliers in the sample had negative, and deteriorating, net equity positions"*[72].

55.3. The converse of this, which is not reflected or addressed anywhere in the Decision, is that every supplier in the Intermediate Position was sufficiently resilient to survive the major energy crisis (and will now be more resilient still, as the other parts of the suite of financial resilience measures come into effect).

55.4. As **Hesmondhalgh 1 §35** explains, *"a Capital Target would have not had any incremental benefit in terms of averting more failures during the crisis"*.

55.5. Further, the Authority has demonstrated no theoretical basis on which it might be said that a notional (or even unusually stressed) supplier needs to be at or above the Capital Target in order to avoid avoidable failure or mitigate systemic risk. The Authority says that it has *"considered the common risks that all suppliers face, including those who are well-hedged"*[73] – but does not explain exactly what those risks were, on what basis they are said to be

[72] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirements and Ringfencing CCBs by Direction,, §1.6, [**NOA1/689**] Underlining added.
[73] Ibid. §1.15 [**NOA1/691**]

common, nor how the Authority could lawfully conclude – in the face of the actual facts of what occurred – that those risks justified the Capital Target.

55.6. The Authority also states that the Capital Target reflects *"a reasonable minimum that we expect a financially responsible, well-hedged, supplier would need to have as a buffer for resilience in the event of a severe but plausible shock"*[74]. However, it is difficult to see why the *"financially responsible"* supplier would consider that their *"buffer for resilience"* in the Intermediate Position was inadequate, given the experience of the crisis, and the Authority has not provided any, or any adequate, explanation.

55.7. Further and in any event, as set out below, the Authority has erred in its calculation of the Capital Target.

56. **Second**, the risks which the Authority appears to consider that the Capital Target will ameliorate are already adequately addressed by the existing regulatory framework. As **Hesmondhalgh 1 Section IV** shows, the applicable common risks are price risk, volume risk, bad debt, weather, tail events, backwardation costs, and shaping and balancing costs, with the first two of these being the most important. The risks relied upon do not therefore justify the Capital Target. In any event, the existing framework has ample tools to address these risks. In particular:

56.1. Ofgem's 5 April 2023 Decision imposed a suite of financial resilience measures, including reporting obligations, *"changing the culture of reporting by placing the onus on suppliers to identify issues early, mitigate their business-specific risks and look longer term how they will comply with their obligations"*[75].

SLC 4A and 4B make provision for extensive financial resilience obligations. Where certain *"triggers"* (i.e., *"indicators of (early) financial stress"*) are reached, suppliers are required to *"proactively report to Ofgem regarding how they are meeting requirements for ongoing financial resilience and to flag where risks arise"* [76]. Suppliers are also required to conduct an *"annual adequacy self-assessment"*[77].

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[74] Ibid. §1.14 [**NOA1/691**]
[75] Decision on Strengthening Financial Resilience [**NOA1/503**]
[76] Ibid. §1.14 [**NOA1/519**]
[77] Ibid. §1.23 [**NOA1/522**]

56.2. Alongside that, Ofgem decided that it would be *"ramping up our monitoring, compliance and enforcement activities"*[78].

56.3. The *"Pillar 2"* framework guards against risks associated with specific suppliers.

56.4. Further there is now a higher bar to market entry. The Authority will refuse to grant licences to prospective suppliers without credible or resilient business plans.

56.5. Yet further, the Authority has now, in the Decision, taken the power to ringfence CCBs.

56.6. In any event, all suppliers can minimize their direct price risk with appropriate hedging.

57. Against this background, the Authority cannot show that the addition of the Capital Target will materially advance its stated objective.

58. **Third,** far from *"deliver[ing] the innovation and positive consumer outcomes needed in the future"*, the imposition of the Capital Target will systematically favour the remaining Big Six and traditional energy supply models, driving down competition and innovation, for the following reasons:

58.1. The definition of capital (for the purposes of determining whether the Capital Target has been met) permits suppliers to have recourse to Alternative Sources of Capital which meet certain requirements. Those Alternative Sources of Capital will be very much more readily available to larger, vertically integrated, traditional suppliers, than smaller challenger ones such as Utilita: see **Bullen 1 §§5.14-5.24**.

58.2. In particular, the only source of capital which does not depend upon the supplier having a well-resourced parent company is an unsecured loan with a term of 12 months or greater, with no right to accelerate the loan. It is obviously very unlikely indeed that a commercial lender would make significant capital available, over a long period, without security or any right to repayment on demand.

[78] Ibid. [**NOA1/503**]

58.3. The position is therefore that suppliers with well-resourced parent companies are effectively exempt from the Capital Target provided the parent provides a guarantee in sufficient amounts, or alternatively a (commercially unavailable) loan facility which could be drawn down in insolvency, while challenger suppliers have to raise the money themselves from somewhere, under (as set out above) regulatory and market conditions which preclude the retaining of profit, and which render debt or equity investment unattractive.

58.4. As a result, established suppliers with vertically integrated businesses will be materially favoured; while challenger suppliers will find it very difficult, and very possibly impossible, to extract themselves from the Intermediate Position.

58.5. Moreover, while in the Intermediate Position (as explained in more detail below), such suppliers are likely to face significant restrictions which impact on their ability to raise sufficient capital to meet the Capital Target and thus have those restrictions lifted, including restrictions on sales, marketing and customer acquisition activity and paying dividends. The result will be that this part of the market will wither away (with no way to increase profits under the price cap, or attract equity investment when it cannot pay dividends to those investors); while its customers will be cannibalised by suppliers with ready and effectively costless access to Alternative Sources of Capital, and will not be able to be replaced since challenger suppliers will not be able to offer competitive prices. Thus, the Decision will make survival in the market difficult for the very challenger entities which drive innovation.

59. The Authority's Impact Assessment does not capture these impacts on competition of a Capital Target or its potential distributional effects from the exit of smaller suppliers from the market, as explained in detail in **Hesmondhalgh 1 §85**. The Authority has not given any or any due weight to the long-term implications of its preference for resilience over competition for consumers. The exit from the market of challenger suppliers would reduce the welfare of all customers, not just those who were previously supplied by the exiting suppliers. Thus, by adopting a measure which so clearly benefits larger, vertically-integrated suppliers, the Authority has failed to take into account, or alternatively, failed to give sufficient weight, to the following mandatory considerations (emphasis added):

59.1. *"to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity"*;

59.2. *"to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part"*;

59.3. *"to promote efficiency and economy on the part of persons authorised by licences"*;

59.4. *"to achieve, in the most cost-effective way, the development of secure, reliable and efficient non-discriminatory systems that are consumer oriented"*;

59.5. *"removing barriers that could prevent access for new market entrants"*;

59.6. *"to increase efficiencies in system performance"*; and

59.7. *"ensuring that customers benefit through the efficient functioning of [the energy market in Great Britain], promoting effective competition and helping to ensure consumer protection"*.

60. In short, by its Decision the Authority has done exactly what it cautioned itself against doing, namely to *"reactively swing from one end of the competition-resilience spectrum to the other"*[79] by promulgating a Decision which will render the business models of (demonstrably financially *resilient*) challenger suppliers unsustainable, thereby reducing rather than promoting competition in the market.

61. **Fourth**, the Authority's conclusion that the Capital Target will *"deliver…positive consumer outcomes"* is wrong. It is based on an impact assessment which concludes that there will be an annual benefit of around £2 per customer. That conclusion reflects errors of fact and/or law, as well as a failure to take into account, or to give sufficient weight to, the mandatory considerations[80]. As **Hesmondhalgh 1 Section VII** shows:

61.1. The Impact Assessment does not consider a range of plausible outcomes that would result in customer losses (which include likely scenarios, such as the price

[79] Ofgem Policy Consultation – Strengthening Retail Financial Resilience §1.16 **[NOA1/133]**

[80] In particular, those set out at paragraph 59 above, as well as *"the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed"*; *"ensuring that system operators and system users are granted appropriate incentives"*; and, *"helping to achieve high standards of universal and public service in electricity supply [or for natural gas], contributing to the protection of vulnerable customers and contributing to the compatibility of necessary data exchange processes for customer switching"* (emphasis added).

cap needing to increase,[81] or suppliers needing to raise debt) (**Hesmondhalgh 1 Section VII.A.**);

61.2. The Impact Assessment is based on recent data which is biased by the energy crisis, but which does not take into account the recent changes introduced to the SLC to increase hedging discipline, as well as the introduction of Pillar 2 of the EFRP;

61.3. The Authority's assumption that the Capital Target will increase credit ratings, such that nearly all suppliers will have a credit rating of 'B' by 2028, is unrealistic and unsupported by evidence (**Hesmondhalgh 1 Section VII.B.**) – and does not take into account the very likely possibility that suppliers may take on more debt to meet the Capital Target requirement;

61.4. The Authority's model does not capture the impact on competition of a Capital Target or its potential distributional effects from the exit of smaller suppliers from the market, as described at paragraphs 58 - 60 above (**Hesmondhalgh 1 Section VII.C.**);

61.5. The Authority has erred in its calculation of hedging exposure and its implications for the consumer interest (**Hesmondhalgh 1 Section VII.D.**);

61.6. The Authority has erred in its assessment of switching costs (**Hesmondhalgh 1 Section VII.E.**). The Authority has based its assessment of switching costs on the suppliers which failed, and does not appear to have considered whether the other regulatory changes that it has implemented mean that it is now over-estimating the costs of switching, as well as the likelihood of supplier failures: **Hesmondhalgh 1 Section VII.E.**; and

61.7. The Impact Assessment (in common with the Authority's general approach) has failed to distinguish between different business models, including with respect to the level of CCBs (**Hesmondhalgh 1 Section VII.F.**).

61.8. The combined effect of these errors is that the conclusion that the Capital Target will *"deliver…positive consumer outcomes"* is unsupportable. Together and

[81] Notably, the Authority itself has expressed the view that that the increased capital requirements will be funded, at least in part, by tariff increases: **Hesmondhalgh 1 §78.**

individually, these errors have the effect that the Authority has disregarded consumer harm which – properly analysed – wipes out any consumer benefit from the Capital Target.

62. For the above reasons, the decision to impose the Capital Target is *"wrong"* and accordingly falls to be quashed in this appeal.

(2) <u>Ground 2: Errors in Setting Capital Target</u>

63. The figure which has been chosen for the Capital Target is the result of methodology which is *"based on unreliable data"*[82] and arbitrary and irrational and is thus an error of law.[83]

64. The Authority's stated methodology was to take as a starting point the historical EBIT margins for suppliers, which are said to be a good proxy for the impact of *"future severe but plausible"* shocks on retained earnings of suppliers[84]. It then calculates a distribution of EBIT margins for 17 suppliers between 2016 and 2022, then takes the 5th percentile value from this distribution, which it estimates to be an 8% loss, and multiplies that loss by the typical annual domestic energy bill of £2,000. The (supposedly) resultant value, £145 per dual-fuel customer, is the starting point for setting the Capital Target level. A reduction per dual-fuel customer to £115 is then applied to anticipate how *"the future market may look different"*[85], including the possibility that risk in the retail market may fall due to changes in the price cap, the impact of the introduction of other resilience measures such as the EFRP, and the fact that the margins reflect supplier-specific risks from having different business models and business practices.

65. However, as explained in **Hesmondhalgh 1 §§38-46**, the Authority's analysis does not appear to be reproducible and appears instead to be based on *"hand-waving"* rather than a firm empirical basis. Its analysis is not (and cannot be, for the reasons given above)

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[82] See *Cadent Gas*, at §3.47, cited above; and s. 11E EA89 and s. 23D GA86, subsections (4)(a), (4)(b) and (4)(c).
[83] Contrary to ordinary principles of public law, in particular, the requirement to act rationally, and thus the appeal should be allowed in accordance with s. 11E EA89 and s. 23D GA86, subsection (4)(e). Further and/or alternatively, Utilita also relies on the ground of appeal in s. 11E EA89 and s. 23D GA86, subsection (4)(c), that *"the decision was based, wholly or partly, on an error of fact"*.
[84] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirement and Ringfencing CCBs by Direction dated 26 July 2023, §1.17 [**NOA1/691**].
[85] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirement and Ringfencing CCBs by Direction dated 26 July 2023, §1.26 [**NOA1/694**].

tied to any *"systemic challenges"* or the recent levels of supplier failure, the mitigation of which is said to be the effect of this measure, for the following reasons.

66. **First**, the premises of the calculation are flawed, with the effect that neither the Authority nor the CMA can have any confidence that the level of the Capital Target is appropriate:

    66.1. The use of EBIT reflects a variety of supplier-specific idiosyncratic risks, not just common risks. Indeed, the Authority has now recognised that the 1.9% EBIT margin allowed over the period to which its analysis relates was insufficient, and it is seeking to increase it. This analysis therefore starts from a point which doubly penalizes the suppliers – it imposes higher costs on them in the form of a higher capital requirement, due to a price framework that under-remunerates their costs in the first place.

    66.2. As a result of this use of EBIT, the calculation of the starting point is highly sensitive to assumptions, which are undefended and unexplained.[86]

67. **Second**, even assuming those premises, there appear to be errors in the analysis in any event. Dr Hesmondhalgh's attempt to reproduce the analysis has been hampered by the fact that the Authority has not shared the details of its distribution of EBIT margin or the data underlying it. However, as Dr Hesmondhalgh shows (**Hesmondhalgh 1 §56**), her analysis has delivered a different result. Further, and in any event, in the April 2023 Consultation, the £145 stating point is said to derive from the fact that the 5th percentile is approximately -9%, as against typical bill levels of £2,000. However, -9% x £2,000 is £180, not £145. It is not clear how the Authority reached the £145 number.

68. **Third**, the subsequent reduction to this (itself inexplicable) number appears to be entirely arbitrary.

    68.1. The Authority has not explained how it takes into account the introduction of other resilience measures, or the fact that certain risks are supplier-specific. That is particularly important in this case, where the Authority has been made aware, by Utilita's consultation response, that risks are not the

[86] As set out below, one key assumption which has been adopted is the time period over which the assessment is conducted – from 2016-2022 – even though results over that period will be biased by the energy crisis.

same for all suppliers, and that this has a material impact on the extent to which a capital buffer is necessary[87].

68.2. The position is, accordingly, that the Authority appears to *recognise* that account should be given to different levels of risk, but does not appear to have undertaken the necessary analysis to determine whether it *has* made sufficient allowance for this in the level at which it has set the Capital Target.

68.3. This important omission is inconsistent with the Authority's obligation under the Directives (set out in paragraph 50 above) to have regard to the *"designated regulatory objective"* of *"removing barriers that could prevent access for new market entrants"*.

69. **Fourth**, idiosyncratic factors caused suppliers to make losses in half of the cases reviewed; while of the remainder, half again were caused by tariffs being insufficient to remunerate their costs: **Hesmondhalgh 1 §54**. Had these matters been controlled for and appropriate assumptions adopted, they would imply a Capital Target of £87 for a customer bill of £2,000.[88]

70. Accordingly, even if some Capital Target were in principle appropriate (which it is not – see above), the level at which it has been set is arbitrary, irrational, and the output of a flawed or erroneous calculation.

(3) Ground 3: Disproportionality of the Capital Target and the Associated Compliance Framework

71. The Authority has failed to have regard, or alternatively, has failed to give appropriate weight, to the principle that regulatory activities should be proportionate and targeted.[89]

[87] Letter from Utilita to Ofgem 'Re: Further Statutory Consultation: Strengthening Financial Resilience– introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction' dated 10 May 2023, [**NOA1/655**].
[88] NB: This analysis still relies upon the erroneous 15% reduction as a general means to account for differences in suppliers' risk, which, for the reasons given above, cannot be supported.
[89] And thus the appeal should be allowed in accordance with s. 11E EA89 and s. 23D GA86, subsections (4)(a) and (4)(b).

72. The imposition of the Capital Target and its compliance framework imposes significant obligations on suppliers in the Intermediate Position. In particular, prior to the approval of a Capitalisation Plan, the supplier will be subject to Transition Controls pursuant to new SLC 4B.18(iii)[90]. That means that it must refrain from:

72.1. All sales, marketing and customer acquisition activity, including the acquisition of any new domestic customers or upgrading of existing domestic customers (the **"Sales Ban"**); and

72.2. Making any payment, providing any loan or transferring any asset to any third party, unless essential (the **"Non-essential Payments Ban"**).

73. The Authority has made clear that it would not expect to approve a Capitalisation Plan which did not include *"some restrictions on payments and growth, albeit not necessarily as strict as the Transition Controls"*[91]; and *"it is likely that most acceptable Capitalisation Plans will include measures to limit non-essential payments and growth in customer numbers"*[92]. The position is therefore that a supplier is likely to remain subject to these controls or controls like them for so long as it is below the Capital Target.

74. These are significant interferences with suppliers' freedom to conduct their businesses. They restrict the attractiveness of suppliers as investment prospects, as well as their growth, limiting the extent to which capital can be raised to meet the Capital Target. They could be justified only if appropriate to achieve a legitimate aim, necessary, and reflective of a fair balance between the interests of the suppliers and the interests of the community.

75. The Capital Targets and associated compliance framework fail on all these counts.

76. **<u>First</u>**, Utilita relies on the facts and matters set out under Ground 1 above to demonstrate that, while the Authority has adopted a legitimate objective, the imposition of the Capital Target has <u>no rational connection</u> with the goal of preventing supplier failure and increasing the resilience of the market to severe but plausible shocks. The measure is therefore neither proportionate nor targeted.

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[90] See Decision Notice Electricity – SLC 4B dated 26 July 2023 [**NOA1/743**]; Decision Notice Gas – SLC 4B dated 26 July 2023 [**NOA1/756**].
[91] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirement and Ringfencing CCBs by Direction dated 26 July 2023, §3.18 [**NOA1/719**].
[92] Further Statutory Consultation: Strengthening Financial Resilience – introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction dated 5 April 2023, §1.21 [**NOA1/587**].

77. **Second,** the level at which the Capital Target is set is both arbitrary (as set out above) and in any event unnecessarily and disproportionately high. In particular, the Authority's decision to adopt a time period for its assessment of 2016 – 2022 is undefended, but its effect is to imply that the unprecedented crisis of 2021-2022 was in fact a 1/7 event, which is *obviously* wrong, since no similar crisis has been seen in at least 70 years. Put in simple terms, the Authority has calculated the Capital Target on the basis that suppliers need to be sufficient resilient to withstand a crisis of the scale of the 2021-22 crisis every seven years. That is a disproportionate level of resilience which will encourage inefficient use of capital (contrary to the legal obligation to give due weight to the promotion of *"efficiency and economy on the part of persons authorised by licences"* in the GA86 and EA89, as well as the obligation to achieve resilient and efficient supply *"in the most cost-effective way"* in the respective Directives). This aberrant result falls outside the scope of any margin of discretion or judgement which may accrue to the Authority.

78. **Third,** the consequences for suppliers of falling into the Intermediate Position are severe, as summarised above. This severity is compounded by the fact that the compliance framework targets, and inhibits, precisely the actions which might otherwise permit a business to attract debt or equity investment; all while the price cap prevents the raising of capital by retaining profits.

79. **Fourth**, what is necessary and proportionate for one supplier will not necessarily be so for others. It is well established that blanket or *"bright-line"* rules are more difficult to justify in terms of proportionality: *Dean v Mitchell* [2023] EWHC 1479 (KB), §116[93]; *R (Tigere) v Secretary of State for Business, Innovation and Skills* [2015] UKSC 57, [2015] 1 W.L.R. 3820, §§36 - 38[94]. The Authority has adopted a one-size-fits-all approach, which results in the imposition of disproportionate burdens on suppliers who have structured their business models in such a way as to minimise risk – exactly the behaviour the Authority says that it seeks to promote. As set out at paragraphs 15 - 16 above, suppliers such as Utilita face low risks of bad debt and have hedging arrangements in place, yet face exactly the same Capital Target as the high-risk/low-resilience business models identified by Oxera in its report (namely, the *"growth model"* and *"timing model"*) and which these measures are designed to address.

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[93] **[NOA1/1163]**
[94] **[NOA1/1090-1091]**

80. The Authority has provided no real explanation for why a blanket approach in this case is appropriate, save for to say that:

80.1. The Capital Target *"aims to set a simple, common minimum with lower monitoring and covering a common set of risks"*[95], which does not explain *why* that is an appropriate thing to do, or *why* the alternative of setting targets based on the level of risk actually faced (even heuristically, along the lines set out in **Bullen 1 §6.3**) would be too complicated. Indeed, as Utilita set out in its consultation response[96], (a) the market is already segmented by various types of supplier with various risk profiles; and (b) the Authority in fact has taken difference in business models into account – where it has sought to hold upside against suppliers (e.g. the allowance for unexpected SVT demand, which prepayment customers do not receive) – but makes no allowance for the different levels of risk which exist for prepayment-focussed suppliers (as to which see **Hesmondhalgh 1 §§74-77**).

80.2. *"[M]any of the key risks are common"* such that the required buffer was not *"sufficiently different between suppliers in the market"*[97]. However, the Authority has not explained *which risks* these are, *why* they are common across suppliers with very different business models, nor whether or why they have been assessed to be *similarly significant* risks across multiple suppliers.

80.3. In the November 2022 Consultation, the Authority considered and rejected the possibility of *"setting the minimum capital requirement as an actual percentage of the capital employed under the price cap return"*[98] on the ground that this would *"introduce complexity and a lack of certainty for suppliers"*. The Authority reached this conclusion on the ground that the price cap is subject to change, and so the Capital Target would fluctuate with it. However, it does not follow from this that a flat rate is necessary or appropriate. That depends on the relative benefits and disbenefits of *"certainty"*, and the Authority has not explained how it reached the conclusion that the former

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[95] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirement and Ringfencing CCBs by Direction dated 26 July 2023, §1.36 [**NOA1/697**].
[96] Letter from Utilita to Ofgem 'Re: Further Statutory Consultation: Strengthening Financial Resilience– introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction' dated 10 May 2023, [**NOA1/655**].
[97] Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirement and Ringfencing CCBs by Direction dated 26 July 2023, §1.33 [**NOA1/696**].
[98] Ofgem Statutory Consultation: Strengthening Financial Resilience dated 25 November 2022, §3.38 **[NOA1/294]**

outweigh the latter in this case. Indeed, exactly the same arguments would justify imposing a blanket figure for the price cap itself – yet, quite rightly, no rational authority would think that a sensible proposal.

81. In fact, suppliers actually face very different types and levels of risk depending upon their business model: **Hesmondhalgh 1 §§19-32**. As explained at **Bullen 1 §§5.25-5.26.3**, counterparty credit risk, credit risk, liquidity risk and operational risk are not common risks at all; and price and volume risk, while common risks, have very different impacts on different types of supplier. The mere assertion that some risks are *"common"* does not – without more analysis, which the Authority has not produced – justify the blanket approach the Authority has taken, which is disproportionate to the risks suppliers face. Further, as set out at **Hesmondhalgh 1 §32,** the Authority is out of step with the financial market resilience measures from which is has drawn inspiration, which are typically calculated as a percentage of a financial institution's risk-weighted assets.

82. **Fifth**, the proportionality of the Capital Target must be assessed against the context of the applicable price cap, which makes the retaining of profits to build up capital impossible: see **Bullen 1 §5.21.**

83. **Sixth,** there is no deadband or flexibility for the case in which a resilient supplier briefly crosses the Capital Target threshold, even though, in its April 2023 Consultation, the Authority recognised that *"there will be times when it is reasonable for a supplier to temporarily dip below the Capital Target in times of stress"*[99]. This gives rise to the prospect of a supplier needing to repeatedly issue and seek approval for Capitalisation Plans, should that supplier's level of capitalisation hover just about the Capital Target (which is likely to be the efficient choice, since the Capital Target level has been designed by reference to what a financially responsible supplier would do).

84. Accordingly, the imposition of the Capital Target ought to be quashed as disproportionate and unnecessary, contrary to the Authority's duties under the EA89 and GA86.

[99] Further Statutory Consultation: Strengthening Financial Resilience – introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction dated 5 April 2023, §1.16 [**NOA1/585]**

E. CONCLUSION AND REMEDY

85. For the above reasons, the CMA ought to uphold this appeal. Utilita respectfully asks the CMA to quash the Decision insofar as it imposes the Capital Target.

ALAN MACLEAN KC

TOM LOWENTHAL

Blackstone Chambers

23 August 2023

I believe that the facts stated in this submission are true. I understand that proceedings for contempt of court may be brought against anyone who makes, or causes to be made, a false statement in a document verified by a statement of truth without an honest belief in its truth.

Signed:

W Bullen

W Bullen (Aug 23, 2023 16:58 GMT+1)

Date: 23 August 2023

WILLIAM BULLEN