

UTILITA ENERGY LIMITED

- and -

GAS AND ELECTRICITY MARKETS AUTHORITY

Decision on Permission to Appeal

1. Under cover of a Notice of Appeal (**NoA**) received by the Competition and Markets Authority (**CMA**) on 23 August 2023, Utilita Energy Limited (**Utilita**) sought permission to bring an appeal under section 11C of the Electricity Act 1989 and section 23B of the Gas Act 1986 against the decision by the Gas and Electricity Markets Authority (**GEMA**), dated 26 July 2023 to, among other things, modify licences to introduce a common minimum capital requirement for gas and electricity suppliers¹ (the **Decision**).

Requirement for permission to appeal

2. Under section 23B(3) of the Gas Act 1986 and section 11C(3) of the Electricity Act 1989, the CMA's permission is required before such an appeal may be brought.
3. I make this decision on permission to appeal in my capacity as an authorised member of the CMA (see paragraph 1(8) of Schedule 4A to the Gas Act 1986 and Schedule 5A to the Electricity Act 1989).
4. In making this decision I have had regard to the NoA, the representations in response made by GEMA on 7 September 2023 (the **Response**) and the further representations in a letter from Utilita's solicitors dated 15 September 2023 (the **Utilita Letter**).

Decision on permission

5. The NoA was received by the CMA within the period prescribed by paragraph 1(3) of Schedule 4A to the Gas Act 1986 and Schedule 5A to the Electricity Act 1989.

¹ Ofgem's Decision on Strengthening Financial Resilience Minimum Capital Requirements and Ringfencing CCBs by Direction, 26 July 2023.

6. Section 23B(2)(a) of the Gas Act 1986 and section 11C(2)(a) of the Electricity Act 1989 both provide that an appeal may be brought by a relevant licence holder (within the meaning of section 23(10) of the Gas Act 1986 and section 11A(10) of the Electricity Act 1989). The Decision relates to the modification of the conditions of Utilita licences. I am therefore satisfied that Utilita is a relevant licence holder within the meaning of those sections.
7. Under section 23B(4) of the Gas Act 1986 and section 11C(4) of the Electricity Act 1989, the CMA may refuse permission to bring an appeal only on one of a number of specified grounds. The potentially relevant grounds in the present case are (i) that the appeal is brought for reasons that are trivial or vexatious, or (ii) that the appeal has no reasonable prospect of success.
8. Utilita seeks permission to appeal the Decision on the following grounds:
9. *Under Ground 1:* GEMA erred in concluding that the Capital Target would further the objective it was intended to achieve.²
 - a. GEMA's stated objective 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".³ The Capital target fails to achieve this effect as (i) the Capital Target will not result in lower levels of supplier failure and mutualised costs; (ii) the effects are already sufficiently achieved by other regulations; and (iii) the Capital Target will have negative effects on the energy market that will undermine innovation and positive consumer outcomes by systematically favouring the favour the remaining Big Six (i.e. British Gas, EDF Energy, E. ON and ScottishPower) and traditional energy supply models.
 - b. There is no evidence that a Capital Target will result in lower levels of supplier failure and mutualised cost and GEMA has shown no theoretical basis that this is the case. Therefore, GEMA has failed to show that the Capital Target was necessary. In the recent crisis, the high levels of supplier failure and mutualised cost were caused by suppliers which fell below the Capital Floor.⁴
 - c. The risks that the Capital Target are aimed at (price risk, volume risk, bad debt, weather, tail events, backwardation costs, and shaping and balancing costs) are already adequately addressed by the existing regulatory

² NoA, paragraph 8.

³ NoA, paragraph 53.

⁴ NoA, paragraph 55.

framework, including the financial resilience measures put in place through GEMA's decision of 5 April 2023.⁵⁶

- d. The imposition of the Capital Target will systematically favour the remaining Big Six (i.e. British Gas, EDF Energy, E. ON and ScottishPower) and traditional energy supply models, driving down competition and innovation. GEMA's impact assessment does not give sufficient weight to the negative impacts on competition and the energy market.⁷
 - e. GEMA's impact assessment errs in: assuming that that the Capital Target will increase credit ratings, such that nearly all suppliers will have a credit rating of 'B' by 2028⁸; its calculation of hedging exposure and its implications for the consumer interest⁹; and its assessment of switching costs.¹⁰
 - f. GEMA's impact assessment does not take account of: a range of plausible outcomes that would result in customer losses¹¹; the recent changes introduced to supplier licence conditions to increase hedging discipline, as well as the introduction of Pillar 2 of the Enhanced Financial Responsibility Principle¹²¹³; the impact on competition of a Capital Target or its potential distributional effects from the exit of smaller suppliers from the market¹⁴; suppliers different business models¹⁵; and overall consumer harm¹⁶.
10. *Under Ground 2: GEMA erred in calculating the level at which the Capital Target ought to be set.*¹⁷
- a. The calculation is based on a distribution of EBIT of seventeen suppliers between 2016-22. The use of EBIT margin is inappropriate because it is

⁵ Decision on Strengthening Financial Resilience, 5 April 2023. This required suppliers to comply with an Enhanced Financial Responsibility Principle, imposing a positive obligation on all suppliers to evidence that they have sufficient business-specific capital and liquidity so that their liabilities can be met on an ongoing basis as well as various reporting requirements.

⁶ NoA, paragraphs 56 and 57.

⁷ NoA, paragraphs 58 to 60.

⁸ NoA, paragraph 61.3.

⁹ NoA, paragraph 61.5.

¹⁰ NoA, paragraph 61.6.

¹¹ NoA, paragraph 61.1.

¹² The Enhanced Financial Responsibility Framework included the following changes to the licence (1) requiring suppliers to have sufficient capital and liquidity to meet reasonably anticipated liabilities as they fall due; (2) introduction of Trigger Points which require suppliers to report at points where changes in their business have, or will have, an impact on their ability to meet their obligations under the enhanced FRP; and (3) annual adequacy self-assessment to enable Ofgem to analyse and assess the efficacy of supplier arrangements to manage risk. Ofgem (April 2023), Decision on Strengthening Financial Resilience, Section 1.

¹³ NoA, paragraph 61.2.

¹⁴ NoA, paragraph 61.4

¹⁵ NoA, paragraph 61.7

¹⁶ NoA, paragraph 61.8

¹⁷ NoA, paragraph 8.

dependent on GEMA's price cap and reflects a variety of supplier-specific idiosyncratic risks, not just common risks.¹⁸

- b. Attempts to reproduce GEMA's calculation by Utilita's independent expert reached different results to GEMA.¹⁹
 - c. GEMA fails to adequately explain the basis for the reduction in the Capital Target from £145 to £115.²⁰
 - d. Some losses by the suppliers used as the basis for the calculation were caused by idiosyncratic factors and some by tariffs being insufficient to remunerate their costs.²¹
11. *Under Ground 3: The Capital Target (at any level, and certainly at the designated level) is unnecessary and disproportionate.*²²
- a. GEMA's calculation is based on data taken from 2016-2022. This selection implies that the 2021-2022 crisis was a 1/7 event, which is wrong. GEMA's decision to select this time period is undefended.²³
 - b. GEMA failed to give appropriate weight to the fact that suppliers have different business models.²⁴
 - c. GEMA failed to give adequate reasons for imposing the same Capital Target on all suppliers.²⁵
 - d. Given the price cap, it is impossible to use retained profits to meet the Capital Target. The only other options for raising capital to meet the Capital Target is through debt or equity finance. However, Utilita's has limited options for such finance.²⁶ The Capital Target would therefore be impossible for Utilita to meet despite the fact that Utilita is a resilient supplier.
 - e. The Decision does not permit deadband or flexibility where a resilient supplier briefly dips below the Capital Target threshold despite GEMA itself recognising that 'there will be times when it is reasonable for a supplier to temporarily dip below the Capital Target in times of stress'.²⁷

¹⁸ NoA, paragraph 66

¹⁹ NoA, paragraph 67

²⁰ NoA, paragraph 68

²¹ NoA, paragraphs 69 and 70

²² NoA, paragraph 8.

²³ NoA, paragraph 77

²⁴ NoA, paragraphs 78 and 79.

²⁵ NoA, paragraphs 80 and 81

²⁶ NoA, paragraph 17

²⁷ NoA, paragraph 83 – NB as with paragraph 82, this paragraph does not explain why the lack of deadband or flexibility is legally problematic. We have therefore set out what we think is the most plausible basis.

12. In the Response, GEMA argued that permission should not be granted in relation to any of the grounds because there is no reasonable prospect that they will succeed for the following reasons:
13. *In relation to Ground 1:*
- a. GEMA argue that the fact that the suppliers who failed during the recent crisis were all below the Capital Floor, does not demonstrate that the Capital Target is unnecessary or does not pursue the intended objective. Utilita misconstrues the objective of the policy and misrepresents the way that it will work in practice.²⁸ The actual objective and need for the Capital Target is to provide a loss-absorbing buffer and early warning, allowing GEMA to intervene 'before it's too late'.²⁹
 - b. GEMA argue that if the Capital Target had been in place before the recent crisis, there would have been lower levels of supplier failure as it would have prevented under-capitalised businesses entering the market, referring to a report by Oxera in support of this counterfactual.³⁰
 - c. GEMA argue that they did give sufficient consideration to the need to balance resilience and competition. They cite GEMA's consultation on this topic; the fact that they imposed a Capital Target, Intermediate Position and Capital Floor mechanism rather than a single minimum capital requirement; the decision to set the level of the Capital Target at a 'reasonable and modest level'; and the fact that Capitalisation Plans are flexible as evidence of the weight GEMA placed on minimising the negative impacts on competition.³¹
 - d. GEMA state that Utilita's criticisms of their impact assessment are misplaced arguing that they did take account of the negative impact of possible exit by some suppliers but reasonably concluded that this was outweighed by improved resilience of the sector.³²
 - e. GEMA state that 'at the heart' of Ground 1 'is the contention that Utilita is an efficient and resilient supplier which is at low risk of failure' including because of its 'business model.' However, 'Utilita's own financial position betrays the fallacy of this position'³³.

²⁸ GEMA representations, paragraph 15.

²⁹ GEMA representations, paragraph 15.

³⁰ GEMA representations, paragraph 16.

³¹ GEMA representations, paragraph 20.

³² GEMA representations, paragraph 22.

³³ GEMA representations, paragraph 18.

- f. GEMA disagree that the Decision is an inflexible “one-size-fits-all” approach.³⁴
 - g. GEMA note that they consider these changes to the market are in the long-term best interests of consumers as a whole, because they will minimise market instability, allowing suppliers to compete fairly, with less regulatory intervention to prevent the failure of weaker firms.³⁵
14. *In relation to Ground 2:* GEMA argue that the Capital Target figure that GEMA arrived at was ‘within the margin of appreciation afforded to the expert regulator.’³⁶
15. *In relation to Ground 3:* GEMA argue that this ground of challenge is based on a misinterpretation of key features of the Decision³⁷:
- a. GEMA reject the claim that the Capital Target does not take sufficient account of the fact that suppliers have different business models and risk profiles noting that the Capitalisation Plan that GEMA require from a supplier in the Intermediate Position can take account of such matters.³⁸
 - b. GEMA also argue that the negative consequences on suppliers from dipping below the Capital Target can be substantially mitigated or avoided if suppliers ensure that they have a credible plan in place to reach the Capitalisation target.³⁹
 - c. GEMA also reject the claim that the Decision does not allow any deadband or flexibility when suppliers dip briefly below the Capital Target noting that GEMA will not necessarily require new Capitalisation Plans each time a supplier dips below the Capital Target so long as the initial plan takes account of these fluctuations.⁴⁰
16. In the Utilita Letter, Utilita argued that in the Response (i) GEMA incorrectly portray the Decision as not being ‘one-size-fits-all’,⁴¹ (ii) to the extent GEMA seek to rely on Utilita’s recent financial position, this fails to recognise that the financial position of Utilita is the result of decisions taken by GEMA,⁴² and (iii) to

³⁴ GEMA representations, paragraph 17

³⁵ GEMA representations, paragraph 21

³⁶ GEMA representations, paragraph 27.

³⁷ GEMA representations, paragraph 29.

³⁸ GEMA representations, paragraph 17 and 29(4)

³⁹ GEMA representations, paragraph 29(3)

⁴⁰ GEMA representations, paragraph 17.

⁴¹ Letter from CMS Cameron McKenna Nabarro Olswang LLP dated 15 September 2023, paragraphs 3.1 to 3.5.

⁴² Letter from CMS Cameron McKenna Nabarro Olswang LLP dated 15 September 2023, paragraphs 2.1 to 2.7.

the extent GEMA seek to rely on the fact that Utilita is the only potential appellant, this is not relevant to the issue of permission.⁴³

17. I have reviewed the NoA, the Response and the Utilita Letter. I am satisfied that each of the grounds of appeal summarised at paragraph 8 above is not brought for reasons that are trivial or vexatious. While the Response expresses substantive disagreement with a number of the grounds, I am satisfied that each ground raises arguable points of substance that will require detailed consideration on appeal. I am therefore unable to conclude that any of the grounds have no reasonable prospect of success.
18. I accordingly grant permission to Utilita to bring the appeal on the grounds set out in the NoA.

Kirstin Baker
Authorised Member of the CMA
21 September 2023

⁴³ Letter from CMS Cameron McKenna Nabarro Olswang LLP dated 15 September 2023, paragraph 4.1.