BEFORE THE COMPETITION AND MARKETS AUTHORITY
IN THE MATTER OF AN APPEAL UNDER SECTION 11C OF THE ELECTRICITY ACT 1989 AND SECTION 23B OF THE GAS ACT 1986

B E T W E E N:

UTILITA ENERGY LIMITED

Appellant

-and-

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

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A. INTRODUCTION AND SUMMARY

a. Introduction

1. This is the response of the Gas and Electricity Markets Authority ("**GEMA**") to the Notice of Appeal dated 23 August 2023 filed by Utilita Energy Limited ("**Utilita"**).

2. The Notice of Appeal (or "**NoA**") sets out Utilita's appeal against GEMA's decision dated 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**").

3. The appeals are brought under s. 11C EA89 and s.23B GA86, which confer on licensees the right to appeal on specified statutory grounds to the Competition and Markets Authority ("**CMA**"). Under s. 11C(3) EA89, the permission of the CMA is required for the bringing of an appeal. By its decision dated 21 September 2023, the CMA granted Utilita permission to appeal.

b. Summary

4. By its Decision, GEMA has introduced minimum capital adequacy requirements for energy suppliers as part of a package of measures to increase financial resilience in the sector. The Decision is the product of a complex assessment of substantial data, comprehensive expert analysis, extensive consultation over a three-year period, and the careful balancing of regulatory objectives.

5. Utilita contends that it is a resilient and innovative supplier which will be unfairly penalised by the requirement to hold minimum levels of capital, and that the measure introduced by GEMA is anticompetitive.

6. Utilita's challenge is ill-founded. The Capital Target is a reasonable and appropriate measure to increase supplier resilience: requiring companies to hold a capital buffer should reduce the likelihood of failure and reduce the costs borne by consumers in the

event of supplier failure because of the existence of this loss-absorbing buffer. Far from being a resilient supplier, in fact Utilita's own financial position provides a clear illustration of the importance of and necessity for the challenged measures.

7. Utilita advances three grounds of appeal. Each is lacking in merit:

    7.1. By its **Ground 1**, Utilita alleges that GEMA was wrong to find that the Capital Target would further the objective it was intended to achieve. That is wrong: the requirement for suppliers to hold a minimum level of capital will help to improve resilience in the supplier market by: facilitating early intervention by GEMA and the supplier to support recapitalisation where a supplier is below the Capital Target; reducing moral hazard through requiring 'skin in the game'; and by reducing the mutualised costs to consumers in the event of supplier failure.

    7.2. By its **Ground 2,** Utilita argues that the level of the Capital Target (£115) is based on erroneous calculations, was the result of an arbitrary reduction, and/or is too high. However, Utilita does not come close to showing that the level which GEMA has chosen is 'wrong'. This ground is premised[1] on *some* level of Capital Target being appropriate. Such a decision is not susceptible to a single, 'correct' answer and is quintessentially a matter for the expert regulator. The careful process which GEMA followed also belies Utilita's suggestion that its decision was arbitrary. Having initially consulted on a wide range of £110-£220 for a capital *requirement*, GEMA then decided on the Floor and Target mechanism. GEMA carried out an analysis of historical Earnings Before Interest and Tax ("**EBIT**") data, which implied a starting point of £145 for the target. Utilita alleges various errors in this analysis, but these do not withstand scrutiny. Having consulted on a figure of £130, ultimately GEMA decided to adopt a more modest Capital Target of £115, towards the lower end of what its evidence could reasonably support. Its decision was informed by a range of evidence: quantitative data, qualitative factors (e.g. "regret risks" of setting the level too high), and consultation feedback. Utilita criticises the reduction to the level of

[1] Utilita accepts for the purposes of its arguments under Ground 2 that "*some Capital Target [was] in principle appropriate"* (NoA §70). [Emphasis added].

the target, but these revisions were all in the suppliers' favour. In light of the foregoing, Utilita's further criticism of the Target as "*disproportionately high*" is inconsistent and unjustified. It is based on a further, unsustainable criticism of GEMA's analysis (NoA §66, §77). In sum, given the inherent uncertainties in predicting the likelihood of future events, and that *any* level of target chosen can be criticised from both directions, the CMA should exercise appropriate restraint. GEMA's legitimate, expert decision as to the appropriate level for the target is not outside the bounds of reasonable regulatory judgement, and its decision should not be disturbed (RIIO-2 Energy Licence Modification Appeals (CMA, 28 October 2021) ("**ELMA 2021**") at §3.79.

7.3. By its **Ground 3**, Utilita contends that the Capital Target (at any level, and certainly at the designated level) is unnecessary and disproportionate. That is wrong. To a significant extent, under this ground Utilita simply repeats points made in Grounds 1 and 2. Leaving those points aside, Utilita criticises the consequences for those who are in the "Intermediate Position" (i.e. below the Capital Target) as "*severe*" (NoA §78). That argument mischaracterises the flexible and supplier-specific compliance framework which GEMA has devised, and which strikes a careful balance between having regard for suppliers' circumstances on the one hand, and achieving GEMA's policy objectives on the other. Further, Utilita suggests that *any* level of Capital Target was unnecessary, citing alternatives which it would prefer (NoA §80-81). However, GEMA rejected more complex permutations of the policy as inferior and/or as disproportionate, for reasons which were reasonable and appropriate.

c. Key documents filed with this response

8. GEMA relies on the following witness statements, filed with this Response:

8.1. The first witness statement of David Hall dated 12 October 2023 (**"Hall 1"**). Mr Hall is GEMA's Deputy Director of Financial Resilience and Controls.

8.2. The first witness statement of Megan McPherson dated 12 October 2023 (**"McPherson 1"**). Ms McPherson is GEMA's Head of Capital Adequacy Policy and Strategy.

8.3. The first witness statement of Rohan Churm dated 12 October 2023 ("**Churm 1"**). Mr Churm is the Interim Director for Financial Resilience and Controls at GEMA.

8.4. The first witness statement of Dr Gavin Knott dated 12 October 2023 (**"Knott 1"**). Dr Knott is GEMA's Chief Economic Adviser.

8.5. The first witness statement of Robert Nesbitt dated 12 October 2023 (**"Nesbitt 1"**). Mr Nesbitt is a Principal Finance Professional at GEMA.

B. LEGAL FRAMEWORK

9. This section sets out the legal framework and relevant principles in an appeal to the CMA against a licence modification decision by GEMA as follows:

    9.1. GEMA's statutory duties;

    9.2. The statutory grounds of appeal, and

    9.3. The standard of review to be applied by the CMA and the scope of GEMA's regulatory discretion.

a. GEMA's statutory duties

10. The relevant provisions of the GA86 and EA89 are materially identical. The discussion below focuses on the EA89 but substantively the same provisions may be found in differently numbered sections of the GA86.

11. Section 3A(1) EA89 establishes GEMA's principal objective as follows:

> *"The principal objective of …[GEMA] in carrying out [its] functions under this Part is to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems."*

12. This is further clarified in s.3A(1A) EA89, which states:

> *"Those interests of existing and future consumers are their interests taken as a whole, including— (a) their interests in the reduction of [gas/electricity]-supply emissions of targeted greenhouse gases; [...] (b) their interests in the security of the supply of [gas/electricity] to them; and (c) their interests in the fulfilment by the Authority, when carrying out its designated regulatory functions, of the designated regulatory objectives.*"

13. Section 3A(1B) of the EA89 imposes a duty on GEMA in respect of the principal objective:

> *"[GEMA] shall carry out [its] functions under this Part in the manner which…[it] 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."

14. Section 3A(1C) EA89 imposes a further duty on GEMA to have regard to the interests of consumers. That section provides:

> *"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 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 Authority ... could carry out those functions which would better protect those interests."*

15. Particular regard must be had to the interests of certain specified groups of consumers. Section 3A(3) EA89 provides:

> *"(3) In performing the duties under subsections (1B), (1C) and (2) ... 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."*

16. Section 3A(6) EA89 deals with the temporal scope of the concept of a "consumer" for the purposes of the obligations set out in s.3A EA89. It states, "*in subsections (1C), (3) and (4) references to consumers include both existing and future consumers*".

17. Further duties are imposed by s.3A(2) EA89:

> *"In performing the duties under subsections (1B) and (1C), ... the Authority shall have regard to:*
>
> *(a) the need to secure that all reasonable demands for electricity are met;*

(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 [and other relevant legislation]; and

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

18. In carrying out functions pursuant to s.3A EA89, GEMA "may" also have regard to the interests of consumers in respect of water, gas or telecommunications. Section 3A(4) EA89 provides:

> *"(4) The Secretary of State and the Authority may, in carrying out any function under this Part, have regard to–*
>
> *(a) the interests of consumers in relation to gas conveyed through pipes (within the meaning of the Gas Act 1986); and*
>
> *(b) any interests of consumers in relation to–*
>
> *(i) communications services and electronic communications apparatus, or*
>
> *(ii) water services or sewerage services (within the meaning of the Water Industry Act 1991),*
>
> *which are affected by the carrying out of that function."*

19. Pursuant to s.3A(5) EA89, subject to subsections (1B) and (2) and to GEMA's duty to carry out functions in a manner best calculated to further delivery of policy outcomes under s.132(2) of the Energy Act 2013, GEMA must carry out its respective functions in a manner which it considers is best calculated:

> *"(a) to promote efficiency and economy on the part of [licensees] and the efficient use of electricity conveyed by distribution systems or transmission systems;*
>
> *(b) To protect the public from dangers arising from the generation, transmission, distribution or supply of electricity or the provision of a smart meter communication service; and*
>
> *(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 [conveyance of gas through pipes /generation, transmission, distribution or supply of electricity] or the provision of a smart meter communication service."*

20. As regards the exercise by GEMA of its statutory functions, s.3A(5A) EA89 provides:

> *"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."*

b. The statutory grounds of appeal

21. The potential grounds of appeal against licence modification decisions are set out in s.11E(4) EA89. The CMA "may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds" (emphasis added). Those grounds are as follows:

21.1. "that GEMA failed properly to have regard to any matter mentioned in subsection (2) [i.e., GEMA's relevant statutory duties]";

21.2. "that GEMA failed to give the appropriate weight to any matter mentioned in subsection (2)";

21.3. "that the decision was based, wholly or partly, on an error of fact";

21.4. "that the modifications fail to achieve, in whole or in part, the effect stated by GEMA by virtue of section 11A(7)(b) EA89"; or

21.5. "that the decision was wrong in law".

22. These grounds are exhaustive. In SONI Limited v Northern Ireland Authority for Utility Regulation (CMA, 10 November 2017), the CMA explained that "[t]he test is whether the CMA is satisfied the regulator's decision was wrong on one or more of the statutory grounds and that the error was material" and "the test is not whether the decision under appeal was "unreasonable" (§3.35).

23. Section 11E(5) EA89 provides: "[t]o the extent that the CMA does not allow the appeal, it must confirm the decision appealed against."

c. **Standard of review to be applied by the CMA and the scope of GEMA's regulatory discretion.**

24. By s.11E(2) EA89, in determining an appeal the CMA must have regard, to the same extent as is required of GEMA, to the matters to which GEMA must have regard in carrying out its principal objective under s.3A EA89; in the performance of its duties under those sections; and in the performance of its duties under ss.3B and 3C EA89 (i.e. to guidance on social and environmental matters, and to health and safety).

25. Pursuant to s.11E(3) EA89, in determining the appeal, the CMA may have regard to any matters to which GEMA was not able to have regard, save that the CMA must not have regard to matters which GEMA would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so. Pursuant to s.11E(5) and s.11F(3), in an appeal to any decision other than a price control decision (such as this appeal), the CMA may refuse the appeal and confirm GEMA's decision, or (if it allows an appeal to any extent) may either quash the decision (to the extent the appeal is allowed) or remit the matter back to GEMA for reconsideration and determination, in accordance with any directions given by the CMA.

26. In the first appeal brought under s. 11C EA89, in *British Gas Trading v GEMA* (CMA, 29 September 2015) at §3.26, the CMA adopted the reasoning of the Competition Commission in an earlier appeal under s.175 of the Energy Act 2004 in *E.ON UK plc* (CC, 10 July 2007):

> *"As a specialist appellate body charged with considering whether a decision of GEMA is wrong, the function of the CC is to provide accountability in relation to the substance of code modifications decisions. However, leaving to one side errors of law, it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator."* (§5.11)

27. In the 2021 Energy Licence Modification Appeals in relation to the RIIO-T2 and GD2 price controls ("**ELMA 2021**"), the CMA noted that the decision in _*British Gas*_ had not been challenged by any party and that the applicable legislation remained unchanged, and that the same standard of review therefore applied: _*ELMA 2021*_ (CMA, 28 October 2021), §3.23. The CMA rejected the submission from WWU that the appropriate standard of review was that of a full rehearing (§3.31). The CMA held:

> "We are required to consider the merits of the Decision but only through the prism of the specific errors alleged by the appellants. The appeals do not entitle the CMA to proceed with a re-run of the original investigation or have a de novo re-hearing of all the evidence. The key question is whether GEMA made a decision that was wrong (on one of the prescribed statutory grounds). Only to that extent must the merits of the Decision be taken into account and we have done so in the present appeals."

28. It is not, therefore, the CMA's role to substitute its judgment for that of GEMA simply on the basis that it would have taken a different view of the matter if it had been the regulator (at §3.27 in _*British Gas*_) (see further _*SONI Limited*_ at §3.36 and _*Cadent Gas*_ at §3.43). The CMA is not to be regarded as a fully equipped regulatory body waiting in the wings - it is "*an appeal body and no more*": see _*T-Mobile (UK) Ltd & Anor v Office of Communications*_ [2009] 1 WLR 1565, §31 (Jacobs LJ) (quoted with approval in _*British Gas,*_ §3.36).

29. On the contrary, the CMA in _*British Gas*_ at §3.28 adopted the further explanation given by the CC in relation to the statutory test (emphasis added):

> *"…our role is to determine whether GEMA's decision is wrong, because it failed properly to have regard to, or failed to give the appropriate weight to, the matters to which GEMA must have regard, or because GEMA has erred in law or fact. In our view, this test* _*clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA's decision is wrong on one of the statutory grounds*_*. For example, GEMA may have taken a view as to the weight to be attributed to a factor which*

differs from the view we take, but which we do not consider to be inappropriate in the circumstances."

30. In *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation* (CMA, 26 June 2017), at §3.20 the CMA summarised the relevant principles from the CC and CMA decisions in the *E.ON* and RIIO-ED1 Determinations as to when a decision is "wrong":

> *"(a) It is for the appellant to marshal and adduce all the evidence and material on which it relies to show that the regulator's decision was wrong.*
>
> *(b) An appeal is against the decision, not the reasons for the decision. Therefore, it is not enough for the appellant to identify some error of reasoning; the appeal can only succeed if the decision cannot stand in the light of that error.*
>
> *(c) Where the appellant contends that the regulator ought to have adopted an alternative price control measure, it is for the appellant to deploy all the evidence and material it considers will support that alternative. It must show that its proposed alternative price control measure should be adopted.*
>
> *(d) Usually an appellant will succeed by demonstrating the flaws in the decision and the merits of an alternative solution. Also, the courts have not ruled out the possibility that there could be a case in which an appellant succeeds in so undermining the foundations of a decision that it cannot stand, without establishing what the alternative should be. In such a case, if there is no other basis for maintaining the decision, the CMA would be at liberty to conclude that the decision was wrong but that it could not say what decision should be substituted. Disposal of the appeal without substituting an alternative decision is not unknown, but is expected to be rare.*
>
> *(e) If the CMA is satisfied that the regulator's decision was correct, then the fact that the regulator's consultation process was deficient ought not to matter, unless that process was so deficient that the CMA cannot be assured that the regulator did indeed get it right.*
>
> *(f) Where a decision of the regulator requires an exercise of judgment, the regulator will have a margin of appreciation. The CMA should apply appropriate restraint and should not interfere with the regulator's exercise of judgment unless satisfied that it was wrong.*

> *(g) A regulator's assessment of the adequacy of the evidence and material before it will not be wrong unless it is outwith the range of reasonable conclusions.*
>
> *(h) If the CMA concludes that the decision can be supported on a basis other than that on which the regulator relied, then the appellant will not have shown that the decision was wrong and will fail."*

31. The CMA's starting point is the error the regulator is alleged to have made; it will not pre-empt the regulator's decision by considering whether an alternative approach might have been better, as explained in *SONI Limited* at §3.29:

> *"we consider that it is not appropriate for the CMA to start by considering an alternative approach and to say that if that approach is considered superior, then there is an error. The first question for the CMA is whether there has been an error in the regulator's approach, not whether am [sic] alternative approach might be better. The question of what alternative approach should be adopted is primarily relevant once an error has been identified."*

32. The type of error that GEMA is alleged to have made also affects the approach the CMA will take.

33. First, where GEMA's decision is alleged to include an error of fact, the CMA will determine whether GEMA was correct in its conclusions as to primary facts, or inferences that it drew from those facts. The CMA in *British Gas* at §3.30 and in *ELMA 2021* at §3.34 adopted the CC's reliance on the Court of Appeal's decision in *Azzicurazioni Generali Spa v Arab Insurance Group* [2003] 1 WLR 577, which reasoned as follows (emphasis added):

> *"where the correctness of a finding of primary fact or of inference is in issue, it cannot be a matter of simple discretion how an appellate court approaches the matter. Once the appellant has shown a real prospect (justifying permission to appeal) that a finding or inference is wrong, the role of an appellate court is to determine whether or not this is so, giving full weight of course to the advantages enjoyed by any judge of first instance who has heard oral evidence. In the present case, therefore, I consider that (a) it is for us if necessary to make up our own mind about the correctness or otherwise of any findings of primary fact or inference from primary fact that the judge made or drew and which the*

claimants challenge, while (b) reminding ourselves that, so far as the appeal raises issues of judgment on unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge's conclusion lay outside the bounds within which reasonable disagreement is possible. In relation to (a) we must, as stated, bear in mind the important and well recognised reluctance of this court to interfere with a trial judge on any finding of primary fact based on the credibility or reliability of oral evidence."

34. Further, the CMA in SONI Limited (§3.31) took into account the view of the CC in the E.ON decision (§5.16) that (emphasis added):

> *"…the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. In some respects, the advantage may be less than that which the trial judge has over the Court of Appeal, because [the regulator's] decisions are not based on the evidence and cross examination of witnesses. [The regulator] nevertheless has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry… For these reasons, the CC will be slow to impugn [the regulator's] findings of fact".*

35. Secondly, as is clear from the passages cited above, where the alleged error lies in the judgment GEMA has made about an unchallenged primary fact or inference, provided GEMA has not made an error of law, the CMA should not substitute its own judgement simply because it would have taken a different view had it been in the position of the regulator. In other words, there is a field of possible judgements in which GEMA may exercise its regulatory discretion lawfully, and reasonable people may disagree about the judgment which is ultimately made. SONI Limited summarised the correct approach at §3.32 and §3.36:

> *"As regards the exercise of discretion, we have taken into account that the CC and CMA have consistently applied the principle in regulatory appeals that the statutory test admits of circumstances in which we might reach a different view from the regulator, but in which it cannot be said that the regulator's decision was wrong on one of the statutory grounds. It is not the CMA's role to substitute our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator….*
>
> *… we consider that there is an important difference between the CMA making up our own mind about the correctness or otherwise of any findings of primary*

fact, or inference from primary fact, made in the Price Control Decision, which is permissible, and the CMA substituting our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator, which is not permissible."

36. Thirdly, where the alleged error lies in GEMA's evaluation of a fact, as distinct from a finding of primary fact, the CMA will regard this as it would an exercise of regulatory discretion. The CMA in *British Gas* at §3.31 explained (emphasis added):

> *"We also agree that where the errors relate to evaluations of fact by GEMA rather than conclusions of primary fact then we should approach such evaluations in the same way that we approach the exercise of discretion."*

37. Fourthly, where an error of law is alleged, the CMA must make its own decision as to what was the correct conclusion, without showing deference to GEMA's reasoning or regulatory discretion.

38. Accordingly, the standard of review applied by the CMA is more intense than the approach taken by the courts in an application for judicial review, but falls short of a full rehearing or appeal on the merits. The CMA will take into account the merits of GEMA's decision, but the question for the CMA will be whether GEMA's decision was wrong on one of the statutory grounds and not whether the CMA would have made the same decision as GEMA, had it been in the regulator's position. The position is encapsulated as follows:

> *"[The CMA is] not only able, but required by EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute": British Gas at §3.24.*

C. BACKGROUND

39. The background to the appeal is set out in detail in the witness statements served by GEMA. In brief, the GB domestic energy market has changed radically since 2010, when there were 12 market participants, to a peak of 70 in mid-2018 (Hall 1, §10). After a long period of relatively low wholesale energy prices, February 2021 saw a sudden spike in the price of wholesale gas. By December 2021, the price of wholesale gas had increased by 500% (Hall 1, §10).

40. Between July 2021 and May 2022, 29 energy companies collapsed (Hall 1, §11). This represented more than 10% of the GB market, resulting in an estimated £2.3 billion of mutualised costs (Hall 1, §§11-12). This does not include any costs from the Bulb Special Administration Regime, which are yet to be finalised. Final costs to the consumer and the taxpayer are not yet known (Hall §12).

41. Plainly, GEMA had to act. In October 2021, GEMA published an Open Letter setting out the steps that GEMA intended to take to stabilise the market (Hall 1, §15). GEMA committed to adjust the price cap methodology; set clear expectations for the industry; and to *"raise the bar"* for suppliers' financial risk management (Hall 1, §15).

42. In December 2021, GEMA published its Action Plan on Financial Resilience, which identified a range of policy options and committed to a review of the regulatory framework (Hall 1, §17). Alongside the action plan GEMA published a statutory consultation on short-term interventions to address volatility (Hall 1, §19). GEMA fairly acknowledged in the statutory consultation that intervening in the market could have the effect of reducing competition; but such interventions might nevertheless be necessary (Hall 1, §20).

43. As part of this programme of work, GEMA developed a number of market wide stress tests (Hall 1, §§22-23). The aim was to test suppliers' exposure to severe but plausible stresses, with a focus on wholesale price and demand shocks (Hall 1, §22).

44. The evidence from GEMA's market wide stress tests showed that there were still a number of financially weak suppliers operating in the market, some with negative net asset positions. (Hall 1, §23).

45. GEMA's stress tests showed that almost all suppliers were weakest under a scenario of simultaneous price and demand shock. While performance in response to such stressors varied with supplier business models, the risk of simultaneous price and demand shock was common across the sector (Hall 1, §24).

46. In January 2022, GEMA commissioned Oxera to report on the root causes of supplier failures during the 2021 crisis. The report, published on 6 May 2022 (**"Oxera Report"**), identified two business models pursued by failed suppliers: (a) the "growth model", where growth in customer balances (deriving from growth in numbers of customers) was used to keep ahead of future liabilities; and (b) the "timing model" where suppliers entered the market at a time of prevailing low spot rates, allowing them to undercut hedged rivals, and offering long-term supply agreements with customers while reducing costs by reducing the coverage or duration of their hedges (Hall 1, §27.1). Some suppliers adopted elements of both models (Hall 1, §27).

47. The Oxera Report identified a number of causes contributing to supplier failures, including negative equity balances, poor liquidity, over-reliance on consumer credit balances to finance operations and/or being unhedged or inadequately hedged (Hall 1, §27.2). The Oxera Report also noted that the owners of energy supply companies had been able to extract assets from the companies and then declare the supplier insolvent, leading to mutualised costs for consumers (Hall 1, §27.4). This created significant moral hazard.

48. The Oxera Report argued that requiring suppliers to raise capital prior to market entry and on an ongoing basis would *"incentivise scrutiny and due diligence of a firm's business plans as investors will want to assure themselves of its prospective and ongoing viability*" (p.26, Hall 1, §29). In short, shareholders should have "skin in the game".

49. Other stakeholders cited similar concerns, including the National Audit Office, which published a detailed analysis of the causes and impacts of supplier failures ("**NAO Report"**) and the House of Commons Business, Energy and Industrial Strategy Select Committee ("**BEIS Select Committee report**") (see further Hall 1, §§48-54). The BEIS Select Committee report recommended that "*increasing capital adequacy will reduce moral hazard and incentivise suppliers to properly hedge and price tariffs in a sustainable way*".[2] The NAO Report did not specifically address capital adequacy requirements but it called on Ofgem to reconsider its approach to ensuring financial resilience in the energy market.[3]

50. In April 2022, GEMA published an Open Letter setting out high level proposals for ringfencing customer credit balances ("**CCBs**"), protecting Renewables Obligation liabilities (**"ROs"**) and setting capital requirements. GEMA ran a series of bilateral meetings and workshops seeking stakeholder feedback in the subsequent months before proceeding to a policy consultation on the capital adequacy proposals in June 2022 (Hall 1, §37).

51. The June 2022 consultation explained that insufficient levels of capital had played a role in supplier failures and explained that GEMA proposed to require suppliers to hold capital at a certain minimum level, and invited stakeholders to make submissions about the level (Hall 1, §§41-45). Respondents differed in their support for the proposals, with some arguing that they should be introduced as quickly as possible and/or needed to be more ambitious, and others arguing that these proposals would make the problem worse (at least in the short term) as market conditions remained challenging (Hall 1, §56).

52. Around this time GEMA also commissioned NERA to undertake analysis for a draft Impact Assessment on the proposed CCB and RO interventions. NERA's analysis showed that, even at the bottom end of the range of effectiveness, these measures would have some net benefits to consumers (Hall 1, §§46-49). However some consultation

[2] Energy pricing and the future of the Energy Market (parliament.uk)P.38 (DH1/18).

[3] The energy supplier market (nao.org.uk) (p.9) (DH1/02).

respondents considered that the impact assessment had underestimated the cost of capital faced by challenger suppliers, and others had concerns about limited supplier access to financial markets (Hall 1, §57).

53. GEMA revised its proposals and impact assessment in light of the consultation responses. GEMA decided to introduce a generous transition period to 31 March 2025, and the impact assessment was refined to include a quantified assessment of the costs and benefits of a capital adequacy regime *in addition to* the ringfencing of CCBs and ROs (Hall 1, §57). GEMA also updated its modelling to reflect stakeholder feedback on short-term effects (particularly financial friction and the increased cost of capital) (Hall 1, §57). The revised impact assessment suggested that a capital adequacy regime may deliver greater benefits than market-wide ringfencing of CCBs (Hall 1, §59).

54. GEMA continued to engage bilaterally with stakeholders (Hall 1, §60).

55. In November 2022 GEMA published a statutory consultation on the introduction of a market wide capital adequacy regime, together with proposals to ringfence Renewables Obligation receipts and to introduce an enhanced Financial Responsibility Principle into the SLCs.[4]

56. GEMA published an impact assessment with the November 2022 consultation (NOA1/17/341), along with draft amended SLCs (MM1/01). The impact assessment included both a quantitative assessment of benefits of the proposals, and also an assessment of associated non-monetised benefits. GEMA proposed that suppliers should be required to hold an amount of capital closely informed by the level of capital that they are compensated for under the price cap, i.e. capital employed under the price cap (Hall 1, §61; McPherson 1, §18). However, GEMA also recognised the volatility in the market and the need to set a trajectory which would balance increasing resilience against further destabilisation if the requirements prompted market exit (McPherson 1, §18).

[4] NOA1/16/238

Accordingly, in the November 2022 consultation GEMA proposed to set a capital requirement somewhere in the range of £110-£220 net assets per domestic customer to be met by 31 March 2025 (Hall 1, §64; McPherson 1, §18). Suppliers would be required to submit transition plans showing "staging posts" for how they intended to meet the requirement (Hall 1, §61-2; McPherson 1, §18) (NOA1/16/288 §3.17). If they fell below the requirement, they would be in breach of their licences (McPherson 1, §19).

57. GEMA received a wide range of feedback in response to the November 2022 consultation. It was clear to GEMA both from the feedback from stakeholders, [redacted] that many suppliers would not be able to meet the capital requirements in time without raising equity, particularly if the level were set at the higher end of the range (McPherson 1, §20). This would be problematic, particularly if several suppliers were seeking to raise capital simultaneously, and GEMA considered that it could have led to a number of costly market exits and/or widespread licence breaches (McPherson 1, §20). Importantly, GEMA's analysis showed that the problems would not be unique to any specific business model or type of supplier (McPherson 1, §20). Although GEMA clearly stated that it was not aiming for a zero-failure market, on balance, GEMA considered that too many suppliers would be unable to meet the capital requirements as proposed and that the proposals in their current form would not be in the interests of consumers overall (McPherson 1, §21).

58. In response to stakeholder feedback from the November 2022 consultation and GEMA's own analysis, GEMA decided to develop the compliance framework, further described below and in McPherson 1 (McPherson 1, §17).

59. By its decision published on 5 April 2023, GEMA decided to proceed with its proposals for ringfencing Renewables Obligation receipts and to introduce the enhanced Financial Responsibility Principle (the **"enhanced FRP"** or **"eFRP"**) into the SLCs. The previous version of the Financial Responsibility Principle required suppliers to manage responsibly costs that could become mutualised and to take appropriate action to minimise such costs (5 April 2023 Decision, §1.2 (NOA1/24/516). The April 2023 Decision was that GEMA would now include a principle in supplier licences that they

are required *"to maintain sufficient capital and liquidity to ensure they can meet their reasonably anticipated liabilities as they fall due."* Mr Churm explains (Churm 1, §34):

> "*The eFRP puts into licence conditions the need for firms to hold sufficient capital and liquidity to meet their reasonably anticipated liabilities. This means that riskier firms are required to hold more capital in accordance with this greater risk, where taking that risk would cause them to no longer hold sufficient capital and liquidity (placing them in breach of the eFRP) [NOA1/32/691 paragraph 1.114]. For example, a firm choosing to hedge a lower fraction of their expected consumer demand could require a larger capital buffer to cover potential price risk and place a licensee in breach if they do not have this. Where a licensee is in breach of, or is likely to breach, its licence obligations, GEMA can take enforcement action which could include an Order requiring the licensee to increase the level of capital they hold where such an order is requisite to bring them back into compliance with the eFRP*.[5]"

60. Alongside the enhanced FRP GEMA introduced a new reporting framework placing the onus on suppliers to identify issues early and to set out mitigations in an Annual Adequacy Self-Assessment (April 2023 Decision, §1.23 (NOA1/36/522), Hall 1, §63-4, Churm 1, §36).

61. In the April 2023 statutory consultation, GEMA proposed that suppliers would be required to maintain a Capital Floor of £0 Adjusted Net Assets per dual fuel equivalent customer from 31 March 2025; and that suppliers meet a Capital Target of £130. Suppliers not meeting the Capital Target would be required to submit a Capitalisation Plan to set out how they intended to meet the target, and they would be subject to Transition Controls until they have such a plan in place (McPherson 1, §43). Suppliers falling below the Capital Floor would be in breach of their licence and GEMA could therefore consider enforcement action. Ms McPherson explains, *"the Floor in effect became the capital requirement and the Target forms part of the capital buffer (the other*

[5] MM1/06

part being comprised of the enhanced Financial Responsibility requirement to have sufficient capital and liquidity for business specific risks" (§36).

62. By proposing to set the Capital Target at £130, considerably below the capital employed under the price cap, GEMA considered that this target was reasonable and would be robust to a range of different business models (Knott 1). Where a supplier was in the Intermediate Position (between the Target and the Floor) they would be subject to Transition Controls designed to mitigate the risk of failure and to incentivise recapitalisation (McPherson 1, §37), until the supplier had developed a Capitalisation Plan approved by GEMA (McPherson 1, §40).

63. Responses to the April 2023 consultation were broadly supportive of the compliance framework (McPherson 1, §45). Feedback on the Transition Controls was mixed, with some suppliers (including Utilita) considering them too harsh, while other stakeholders contended that they should continue to apply until the Capital Target had been reached (rather than ceasing to apply when an acceptable Capitalisation Plan was in place) (McPherson 1, §45).

64. The Decision was published on 26 July 2023.

65. In its final Decision, GEMA decided to maintain the compliance framework as per the April 2023 consultation, but to reduce the level of the Capital Target to £115 Adjusted Net Assets per domestic dual fuel equivalent customer (McPherson 1, §53, Knott 1). The Capital Floor (£0) remained the same.

66. In the Decision, GEMA also refined the definition of capital to remove intangibles (since they lack the capacity to be loss-absorbing in times of stress) and to develop the definition of Alternative Sources of Capital (Decision §§2.18-2.50 (NOA1/32/705-714); McPherson 1, §54). The guiding principles for acceptable Alternative Sources of Capital are that they *"strike the right balance between reducing costs for consumers while meeting our policy objectives of being loss absorbing, reducing mutualised costs, and increasing skin-in-the-game"* (Decision, §2.22 (NOA1/32/706). GEMA accepted that, *"while there aren't currently many instruments in the market for independent suppliers,*

we should be open to considering additional facilities should they become available" (Decision, §2.22 (NOA1/32/706)). The list of permitted Alternative Sources of Capital (which are able to count towards meeting both the Capital Floor and Capital Target) is at Decision, §2.26 (NOA1/32/707-8).

D. <u>RESPONSE TO GROUND 1: THE CAPITAL TARGET ACHIEVES ITS OBJECTIVE</u>

a. <u>Introduction</u>

67. By its first ground of appeal, Utilita argues that GEMA erred in deciding that the Capital Target would further the objective it was intended to achieve (NoA §§52-62).

68. The objective of the reforms was set out in the Decision at [NOA1/32/677] as follows:

> *"We are reforming the retail sector so that we do not see the extent of supplier failures we have seen over the past two years and the accompanying adverse impact on consumers. These reforms, alongside earlier decisions such as establishing the enhanced Financial Responsibility Principle and ringfencing the Renewables Obligation, are aimed at both reducing the likelihood of future supplier failures and reducing the cost of failure to consumers should suppliers fail."*

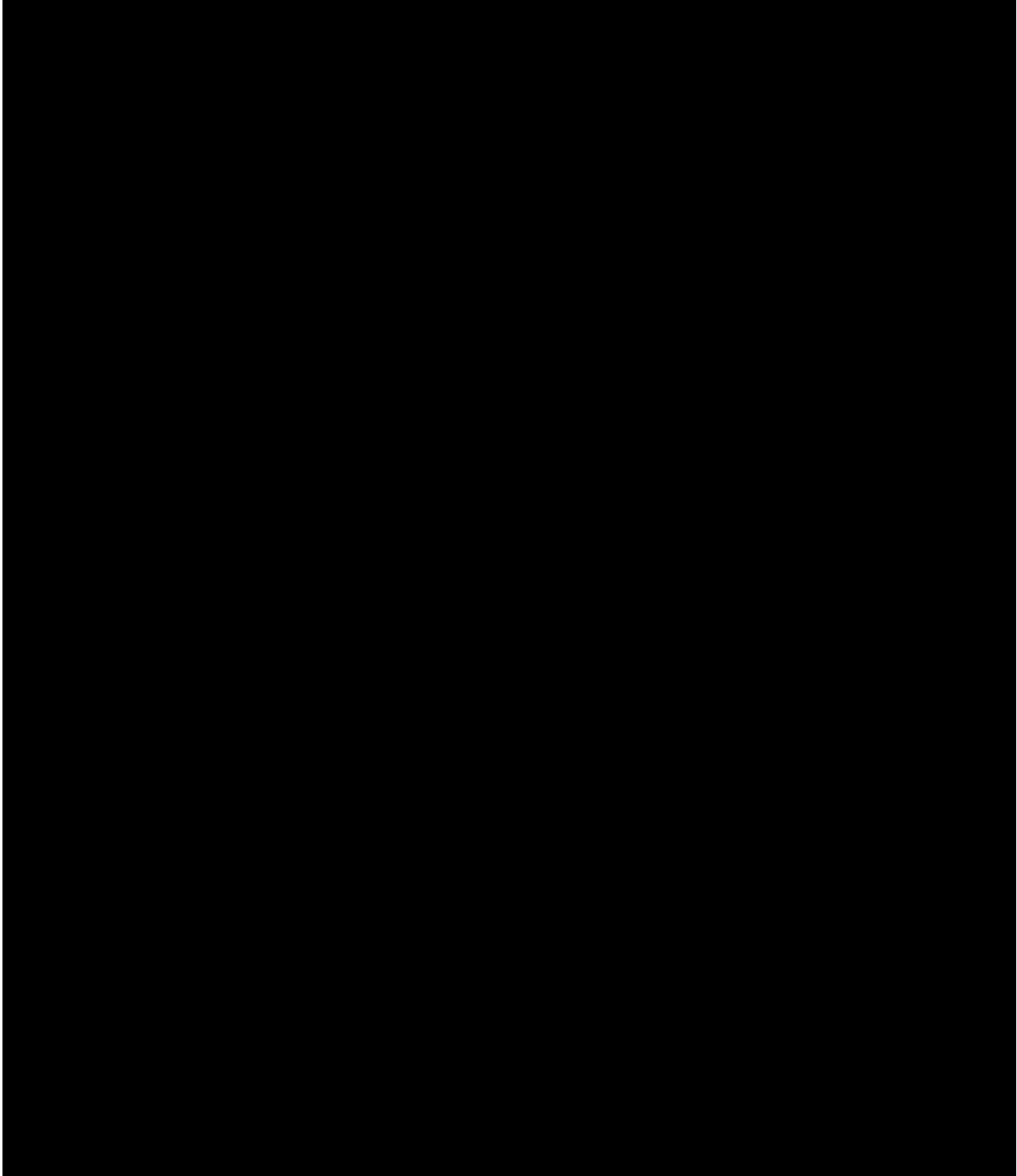
69. Utilita's challenge is misguided: At present, for a company at or around the Capital Floor, the shareholders have little or nothing to lose and everything to gain by a supplier in a precarious position continuing to trade. The shareholders have limited liability. Further losses are borne by the industry, the Government and, ultimately, taxpayers. But if the supplier takes risk and trades out of its difficulties, the shareholders receive all of the upside. One objective of the Capital Target is to ensure that in the future, there is a better buffer to absorb losses without supplier failure, combined with a flexible mechanism for early intervention and resolution. The licence amendments under challenge will help to achieve that objective.

b. <u>Utilita's financial position</u>

70. Utilita's financial position provides an illustration of the need for and importance of the measures under challenge. Utilita's published accounts show that its auditor, Evelyn Partners, consider there to be a material uncertainty related to their going concern (Nesbitt 1, §17). Mr Nesbitt also explains the following:

70.1. Utilita is 100% owned by a company called Utilita Group Limited ("**UGL**"), of whom the majority shareholder is Mr William Bullen (Nesbitt 1, §7).

70.2. Utilita has agreed a Preferred Supplier Agreement with a company called BP Gas Marketing ("**BPGM**").



c. **Background**

71. The process which led to the decision to set a Capital Target is described in detail in the witness statements filed in support of this appeal and summarised in Section C above.

72. As to the policy justification, Mr Churm explains that Ofgem's proposals for minimum capital requirements drew on the approach adopting in the banking sector. At §24, Mr Churm explains, *"The ultimate public policy motivation for capital requirements in banking is because of the externalities in failure"*. That policy rationale also applies in

the energy sector. Minimum capital requirements aim to ensure that energy suppliers have the ability to absorb losses, so that losses are not mutualised to consumers (Churm 1, §25). As Mr Churm explains, mandating a capital buffer provides a better balance of risk between shareholders (who receive the upside of the profits) and consumers (who bear the risk of failure) (Churm 1, §42). In particular, while firms may still fail:

> *"a firm which meets the £115 Capital Target losing, for example, £145 per dual fuel customer and going into failure would be in a better position, with very likely lower mutualised costs, than one that started with zero net assets"* (Churm 1, §43).

73. This policy also seeks to address moral hazard by increasing "*skin in the game*". This factor was highlighted in the Oxera Report [RNOA1/01/41 §2.8] which noted that some suppliers entered the market and grew with negative equity capital, but were then able to leave the market costlessly (to them) when the downside materialised (Churm 1, §47). Mr Churm notes that this was unsurprising given the financial incentives, but that *"suppliers acting in this way might have crowded out other potential entrants who preferred not to join"* (Churm 1, §47).

74. GEMA is not aiming for a zero-failure energy market: there is no desire for "the stability of the graveyard" (Churm 1, §27). However given the incentives for firms to engage in risky behaviour, GEMA reasonably concluded there is a role for the regulator in setting minimum capital requirements (Churm 1, §28 and footnote 19), going beyond the requirement to hold £0 Adjusted Net Assets per customer (the Capital Floor).

75. Utilita appears to accept that principle, since they do not challenge GEMA's decision to require suppliers to remain above the Capital Floor. That is important because it undermines Utilita's contention that a "one-size-fits-all" approach can never be justified in principle. If that were true, following through the logic of Utilita's position, it would be inappropriate in principle for GEMA to have set the Capital Floor at the same level for all suppliers. But that is not Utilita's case.

76. Utilita's position on this betrays the fact that the gravamen of their challenge is not to the decision to set a Capital Target in principle, but rather to the precise level at which the Capital Target has been set. Utilita accepts that suppliers should not be trading with negative equity (regardless of business model/payment type) but nevertheless argues that some suppliers should be permitted to trade with £0 adjusted net assets per customer on the basis that they are "innovative" and/or have already demonstrated their resilience, by virtue of having survived the 2021-2 crisis.

d. Response to the ground of appeal

78. Utilita contends that the imposition of a Capital Target will not achieve its objectives for four reasons: first, because an energy market with a Capital Target will not face materially lower levels of supplier failure and mutualised cost than one without one (NoA §55); secondly, because the risks which the Capital Target is designed to address are already adequately addressed in the existing regulatory framework; thirdly, because the Capital Target is said to systematically favour traditional suppliers, at the expense of competition and innovation (NoA §58); and

79. fourthly because GEMA's impact assessment was flawed. Each of these arguments is wrong for the following reasons, which are developed further below.

79.1. As to levels of supplier failure: GEMA reasonably concluded in light of the extensive evidence available to it that the Capital Target will materially contribute to resilience. Requiring suppliers to put in place a capital buffer will improve the balance

of risk between shareholders and consumers and, by ensuring *"skin in the game"* will help to drive appropriate approaches to risk by company management.

79.2. As to the ability of the existing framework adequately to address risks: the Capital Target is a central feature of GEMA's proposed regulatory framework and it is wrong to contend that the risks can be adequately addressed without it. The Capital Target is part and parcel of the compliance framework which allows GEMA to take early intervention to mitigate the risks of failure and to minimise the costs of failure to consumers.

79.3. As to the impact on competition, the Capital Target and compliance framework takes appropriate account of suppliers' different business models and does not unfairly favour traditional energy suppliers. GEMA is not required to promote competition at all costs; but in any event, the measures under challenge will foster sustainable competition. While it is true that vertically integrated suppliers may have more ready access to capital from a parent, GEMA has made appropriate adaptations to the policy, including through the definition of Alternative Sources of Capital, to accommodate other business models while still achieving its objective of requiring companies to build a capital buffer.

79.4. As to the Impact Assessment, Utilita's criticisms are unfounded. The Impact Assessment was robust and it correctly found that there would be sufficient consumer benefit from this aspect of the proposals to outweigh the costs. In any event, in response to Utilita's appeal, GEMA has run additional sensitivities through the model, and these also support GEMA's conclusion that the Capital Target is in the interests of consumers.

Materially lower levels of supplier failure and mutualised cost

80. Utilita contends that supplier failures in the 2021-2 crisis were caused, not by companies falling below the Capital Target, but rather by companies falling below the Capital Floor (NoA, §55). That misses the point, for at least five reasons:

80.1. First, the fact that the companies which failed were those which fell below the Floor is indicative of the need for GEMA to intervene earlier, to prevent the Floor being breached at all. That is what the Capital Target, together with the compliance framework, achieves. A key objective of the measures is that where a company falls below the Target, the regulator and supplier can intervene (through the development of a Capitalisation Plan by the supplier and its approval by GEMA), before the supplier reaches the Floor. The problem identified by GEMA, and supported by a range of other stakeholders (see paragraph 49 above), is that once suppliers breached the Floor it was largely too late to turn them around, and that the consequence of supplier failure and large mutualised costs became all but unavoidable. The Capital Target is designed to increase resilience by ensuring a buffer to reduce the prospect of the Floor being breached at all.

80.2. Secondly, if minimum capital requirements had been in place before the crisis, they would have operated to prevent under-capitalised businesses from entering the market in the first place. Mr Churm explains that the unsustainable business models of the failed suppliers may have *"crowded out other potential entrants who preferred not to join"* (Churm 1, §47).

80.3. Thirdly, by requiring *"skin in the game"* the Capital Target incentivises a better balance of risks between shareholders (who benefit when things go well) and consumers (who suffer when things go badly). The need for "*skin in the game"* is a crucial antidote to moral hazard. The independent Oxera report supports the view that appropriate levels of *"skin in the game"* would have led to a market of suppliers that were better able to absorb shocks.[6]

80.4. Fourthly, Utilita is wrong to suggest that GEMA failed to consider the nature of the risks faced by suppliers. GEMA has given careful consideration to these risks: see e.g. Hall 1, §§22-24, explaining that stress tests conducted by GEMA highlighted that (for example) all suppliers were weakest under a scenario of simultaneous price and

[6] Oxera, May 2022, p.7 Review of Ofgem's regulation of the energy supply market.

demand shock; see also Knott 1, §17, referring to price risk and counterparty credit risks, and bad debt risk (notwithstanding that some of these risks will affect different suppliers differently). As Dr Knott explains, *"The aim of a loss-absorbing buffer is to support even a low-risk supplier against residual risks that cannot be mitigated, where losses will occur"* (§18). Indeed the fact that suppliers can be impacted differently by these common risks is a key reason why GEMA set the Capital Target at a modest level of £115 (less than one third of the £368 level of capital employed per customer under the price cap: see Churm 1, §20). The prospect of agreeing a supplier-specific Capitalisation Plan with GEMA also allows for considerable flexibility for suppliers as to how and when to reach the Target.

80.5. Fifthly, GEMA did consider specific risks to PPM suppliers, such as Utilita. Mr Churm explains that, while GEMA accepts that the liquidity/cash flow risks are significantly lower for PPM and Direct Debit customers than for Standard Credit customers (Churm 1, §62) that did not mean that a different loss-absorbing buffer was required depending on payment type (Churm 1, §63). This is for a number of reasons (Churm 1, §§64-69) but in particular, GEMA reasonably concluded that *"the majority of sources of risk are invariant to customer payment type"* (Churm 1, §67). One significant risk that some suppliers take [redacted] s speculating on wholesale energy prices by varying their hedge ratio (Churm 1, §67). The profits of such speculation do not relate to customer payment type, and the losses are likely to be mutualised across customers, regardless of payment types (Churm 1, §67). Nevertheless, the variation in risks between suppliers was one reason that GEMA decided to set the Capital Target significantly lower than it might otherwise have done (and significantly lower than was first proposed in the November 2022 consultation: see paragraphs §55 to §58 above. While the initial proposal was (in effect) to set a "floor" in the range of £110-220 adjusted net assets per customer, breach of which would be a breach of the licence, this was lowered very substantially in the final Decision. The Decision adopts a Capital Floor of £0 alongside a Capital Target of £115 adjusted net assets per domestic dual-fuel customer. Notably it is not a breach of the licence to fall below the Capital Target although it does trigger intervention

through the compliance framework. It is only a breach of the licence to fall below the Floor. These were substantial amendments in favour of flexibility to suppliers, such as Utilita. There is an appropriate degree of flexibility to accommodate PPM business models. GEMA reasonably concluded that a hypothetical pre-payment supplier would still be able to make a profit under the price cap and earn a return on the capital required to use as a capital buffer: see Churm 1, §95.

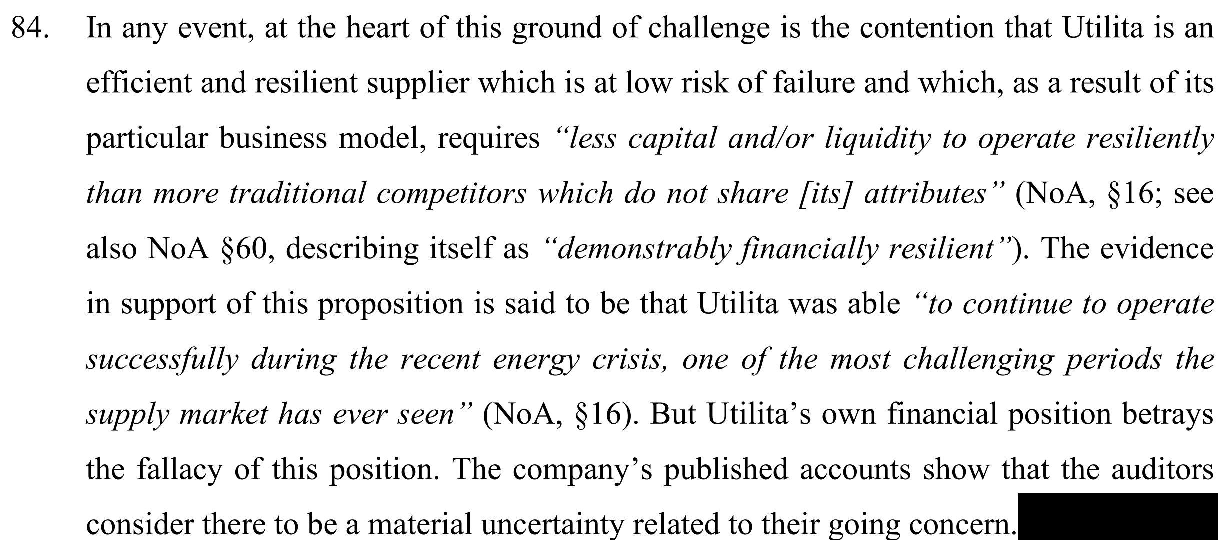
81. It is therefore wrong and simplistic to assert (*cf* Hesmondhalgh 1, §35, NoA §55.4) that the Capital Target would not have had any incremental benefit in terms of averting more failures, because the only suppliers which failed were those which fell below the Floor.

82. Utilita argues (NoA at §79) that GEMA's Decision is an inflexible "one-size-fits-all" approach. But that is a simplification of the policy. Mr Churm explains that there are in fact *"two buffers, one market wide (Capital Target), and one idiosyncratic (FRP obligation SLC4B.1), with the onus on suppliers to assess themselves in the first instance"* (Churm 1, §70). While there is an element of the plan which is market-wide (the Target), there is significant flexibility in how the Target is reached and the timetable for doing so: all that is required is that suppliers who are at risk of falling below the Target seek to put in place a Capitalisation Plan with GEMA. It is for companies to develop their own Capitalisation Plans, taking account of their own risk profile, business model, customer base and management decisions (see also GEMA's response to Ground 3, **SECTION F** below).

83. Where a supplier in the Intermediate Position has a credible Capitalisation Plan in place, which has been approved by GEMA, it will not be subjected to GEMA's default Transition Controls (see Decision at §3.10). Nor is it necessarily the case that new Plans will be required each time a supplier falls below the Target (*cf* NoA, §83): the Decision was clear that *"instead, suppliers may take account of these fluctuations in their*

Capitalisation Plan, which may reduce the need for multiple Plans/substantive changes of Plans" (Decision, §3.12) **[NOA1/32/718]**.

84. In any event, at the heart of this ground of challenge is the contention that Utilita is an efficient and resilient supplier which is at low risk of failure and which, as a result of its particular business model, requires *"less capital and/or liquidity to operate resiliently than more traditional competitors which do not share [its] attributes"* (NoA, §16; see also NoA §60, describing itself as *"demonstrably financially resilient"*). The evidence in support of this proposition is said to be that Utilita was able *"to continue to operate successfully during the recent energy crisis, one of the most challenging periods the supply market has ever seen"* (NoA, §16). But Utilita's own financial position betrays the fallacy of this position. The company's published accounts show that the auditors consider there to be a material uncertainty related to their going concern.



85. Indeed, the evidence provided by Utilita with its NoA and publicly available in its statutory accounts underlines the reasons why a Capital Target is justified, both to ensure that shareholders have *"skin in the game"* (thus incentivising appropriate behaviour by company management), and to facilitate any necessary regulatory intervention to support recapitalisation when the company is below the Target. Overall, this achieves the key objective of better balancing the risk between shareholders and consumers in the event of a shock. Utilita's own circumstances show why it is important that the objectives of the measure, as set out in the Decision,[7] are met.

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[7] See Ofgem's Decision, §2.9: "we want to ensure that shareholders have capital at risk in the company to drive the right behaviours and that their risk tolerance for investing in the company aligns with consumers' reasonable expectation that shareholders ensure that the company directors are managing

86. The fact that suppliers in the Intermediate Position (between the Target and Floor) survived the crisis does not prove that their buffer for resilience is adequate (NoA, §55.6, Dr Hesmondhalgh at §§57-58). On the contrary, Dr Knott explains that *"Both those that survived, and those that did not, lost money during this event. Those that survived were able to absorb those losses and continue to trade even in negative equity positions, either through a capital buffer to absorb losses, or because they were able to take out loans or utilise other financial arrangements"* (Knott 1, §48). In fact, close analysis of the companies in the Intermediate Position (including Utilita, as to which, see §70.4 above) shows that a capital buffer, whether of equity or appropriate loan instruments, does help to ensure resilience to market shocks (Knott 1, §48).

The adequacy of the regulatory framework

87. Utilita is wrong to contend that the existing framework (in the absence of the Capital Target) has *"ample tools"* to address common risks, and that the addition of the Capital Target will not materially enhance these tools.

88. The argument advanced in the NoA is little more than assertion, but in any event it is misconceived for at least three reasons:

88.1. First, if Utilita were correct that survival of the 2021-2 crisis is proof of underlying resilience then the changes relied upon by Utilita at NoA §§56.1-6, and indeed the Capital Floor (which Utilita accepts) would not be required at all.

88.2. Secondly and in any event, GEMA conducted an Impact Assessment on the benefits of its package of proposals, including the Capital Target, and it found that there would be average annual benefits to customers across the evaluation period (2023-2028) of £250m over the next five years (see further Knott 1, §78). The Capital

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the company for the medium to long-term, and have considered solvency in a shock scenario. It is also in the consumers' interest that there is a better balance of risk between shareholders and consumers when a company suffers a loss or if the company is mismanaged. A capital buffer aims to improve that balance of risk." **[NOA1/32/701]**

Target and compliance framework together make a material contribution to those benefits.

88.3. Thirdly and importantly, absent the Capital Target (and compliance framework of which it forms a part), GEMA would be deprived of its suite of early intervention measures which form a key component of these proposals. To the extent that Utilita contends that there is no need for a Capital Target because (inter alia) *"all suppliers can minimise their direct price risk with appropriate hedging"* (NoA §56.6) The evidence suggests that at least some suppliers do not minimise their direct price risk with appropriate hedging. There remain financial incentives to speculate, and in the absence of any requirement to hold capital there remains significant moral hazard when shareholders are able to benefit from the upside of such speculation, but exit the market when the downside materialises, socialising the cost.

The Capital Target does not unfairly favour traditional suppliers

89. Utilita further contends that the Capital Target "*will systematically favour the remaining Big Six and traditional energy supply models, driving down competition and innovation*" (NoA, §58) and that GEMA "*has not given any or any due weight to the long-term implications of its preference for resilience over competition for consumers*" (§59). That is wrong. GEMA has given careful consideration to the need to strike a balance between resilience and the benefits of competition for consumers. It consulted widely on this topic (see, e.g., Decision at §§1.10-1.13; 1.30-1.36; 2.18-2.45, 3.38-3.43, **[NOA1/32/672]**). The decision to introduce the Capital Target reflects a careful regulatory judgement striking an appropriate balance.

90. GEMA has sought to counteract the very real problem of moral hazard created by (in essence) risk-free trading into an energy crisis by challenger suppliers, and (on the other

hand) recognition of different business models and innovation in the market. Indeed, that is a key reason why GEMA introduced a Capital Target, Intermediate Position and Capital Floor mechanism, rather than impose a single minimum capital requirement where failure to hold that capital would contravene the licence. It is also why the Capital Target has been set at what GEMA considers a reasonable and modest level, with an appropriate transition period; and why Capitalisation Plans are supplier-specific, and do not set out (for example) a required timescale or method of recapitalisation. Suppliers can work to recapitalise as quickly as their specific circumstances reasonably allow.

91. Further, GEMA considers that 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.

92. Utilita is correct to note that the definition of capital permits suppliers to have recourse to Alternative Sources of Capital which meet appropriate requirements (*cf* NoA, §58.1). These are funding sources that are not equity capital, but which GEMA has decided to accept as meeting the regulatory requirements (such as long-term committed unsecured guarantees from investment grade parent companies; and, following representations from Utilita, long-term unsecured loans from third parties) (Churm 1, §109). Mr Churm explains that, were it not for the inclusion of these Alternative Sources of Capital, the impact on suppliers (including Utilita) would have been more onerous; and that while GEMA acknowledged that *"some forms of alternative capital could be cheaper than others"*, GEMA did *"not think it would be right to exclude business models that meet our objectives and can provide consumer benefits at lower cost, simply because not all suppliers can use it'"* (Churm 1, §109). GEMA does not agree with Utilita that competitive advantage deriving from financial strength is a problem *per se* (Churm 1, §101 and Decision [NOA1/32/713].

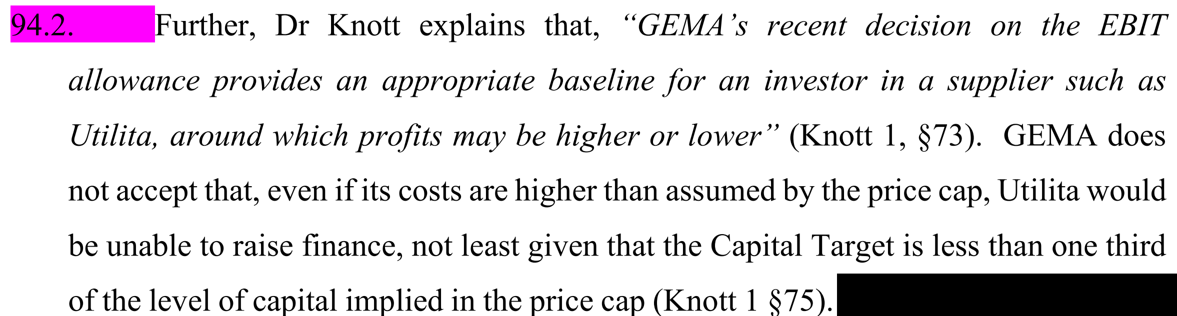
93. Given the level at which the Capital Target has been set (which is around one third of the working capital under the price cap: see further the Response to Ground 2, below), the available transition period to March 2025, and the ability of suppliers who expect to be

in breach of the Target to develop and agree Capitalisation Plans with GEMA in advance of March 2025, there is no unfair burden on any individual supplier.

94. In response to the specific points raised by Dr Hesmondhalgh (see §§59-66), each of these is misplaced:

94.1. GEMA accepts that some suppliers will need to raise finance to meet the Capital Target (Knott 1, §70). It is accepted that raising capital can be difficult, particularly in extremis, and that is why suppliers need to ensure that they have sufficient capital before the crisis hits. GEMA considers that the cost of capital is adequate to attract investment and that investors in the notional efficient supplier can attract reasonable returns in the future.

94.2. Further, Dr Knott explains that, *"GEMA's recent decision on the EBIT allowance provides an appropriate baseline for an investor in a supplier such as Utilita, around which profits may be higher or lower"* (Knott 1, §73). GEMA does not accept that, even if its costs are higher than assumed by the price cap, Utilita would be unable to raise finance, not least given that the Capital Target is less than one third of the level of capital implied in the price cap (Knott 1 §75).



94.3. GEMA also accepts that *"beyond a certain point improving resilience does come at a cost"* (Churm 1, §110). However the decision to introduce the Capital Target and compliance framework strikes a reasonable and appropriate balance between resilience and maintaining competition (Churm 1, §110).

94.4. GEMA's Impact Assessment found that the Capital Target would have limited impact on consumer benefits deriving from competition, even if a small number of suppliers left the market (especially if the suppliers leaving the market were those which were unsustainable in any event) (Churm 1, §110). There remains *"ample room to compete and diversify"* (Churm 1, §111), demonstrated by the interest in entering

the market from potential new suppliers since the April 2023 statutory consultation and the Decision (Churm 1, §114). Utilita is therefore wrong to suggest that the Decision will make survival difficult for "*challenger entities*" per se (NoA, §58.5). It is accepted however that where *"challenger entities"* are thinly capitalised and financially irresponsible, they may find it difficult to comply with these requirements. That is part of the discipline which these measures are designed to encourage.

GEMA's Impact Assessment was robust

95. Utilita's criticisms of GEMA's Impact Assessment are misplaced (NoA, §61). GEMA gave careful consideration to the impact of these proposals, including in relation to competition concerns and the distributional impact across customers (IA, §5.10).

96. Dr Hesmondhalgh contends that the benefits demonstrated by GEMA's IA are insufficient to justify intervention. That is wrong: even on her own analysis (which GEMA does not accept) the asserted benefit of £2 per customer from the Capital Target would represent a net benefit of £250m over the next six years (Knott 1, §78). That is a significant benefit; and it is in addition to the benefit from more sustainable competition in the retail energy market as a whole (Knott 1, §82 and Figure 9).

97. In any event, GEMA's analysis in the IA was conservative (Knott 1, §§79-82). GEMA deliberately adopted a cautious approach to assessing benefits, but even on this cautious approach, over a short period of time (6 years) the benefits were *"clearly positive across all reasonable sensitivities"* (Knott 1, §81). Dr Knott explains that *"Standing back and looking at the issues in the round… Dr Hesmondhalgh's various criticisms relate to matters which are largely peripheral to the primary finding in the IA: that there would be net benefits from a Capital Target by reducing the risk of supplier failure"* (Knott 1, §85).

98. Utilita is wrong to contend that there are a range of plausible outcomes which are not addressed by the IA (*cf* Utilita NoA §61.1 and Hesmondhalgh 1, §75). In response to Dr Hesmonhalgh's specific assertions:

98.1. In relation to the possibility of increasing returns in the default price cap (Hesmondhalgh, §78), Dr Knott explains why this is not a realistic concern, given that the EBIT provides a significantly higher capital base than the level of the Capital Target (Knott 1, §95).

98.2. In relation to raising debt to finance the Capital Target, leading to weaker credit ratios (thus undermining the IA) (Hesmondhalgh, §79-84): Dr Knott explains that, while it is possible that companies may need to raise debt to improve their financial position, in practice this is not a material risk (Knott 1, §97). There is currently no debt outside the vertically integrated suppliers that would qualify as Alternative Sources of Capital, and standalone energy suppliers are unlikely to be in a position to raise unsecured debt (Knott 1, §97).

98.3. In relation to competition and distributional effects on consumers (Hesmondhalgh, §§85-86), GEMA disagrees that there ought to have been a quantitative assessment of the impact of the Capital Target on competition (Knott 1, §103). It is not practicable to attempt to quantify the level of investment and innovation that will result from a change in market conditions of this kind. The reasoning in the qualitative assessment is robust and is supported by detailed economic analysis sufficient to demonstrate the benefits of the measure (Knott 1, §103). The IA does acknowledge the possibility of market exit, but it was not quantified because (i) it is impossible accurately to predict; (ii) GEMA does not envisage significant levels of supplier exit as a result of the Capital Target; and (iii) if any suppliers do exit, it is reasonable to expect that they will be the suppliers which are least attractive to investors (Knott 1, §105).

98.4. In relation to switching costs (Hesmondhalgh §§91-93), it was necessary to use evidence of switching from pre-crisis pricing because it is impossible to predict how this would change in the future in the absence of the policy (Knott 1, §111). However, using the IA model published alongside the Decision, GEMA has now conducted further analysis to test whether its assumption of switching costs is too high (Knott 1, §86). This analysis showed that changing the assumptions to those preferred by Dr

Hesmondhalgh would have no material effect on the conclusions of the IA (Knott 1, §86).

98.5. In relation to hedging exposure (Hesmondhalgh, §§87-90), it is not correct that GEMA underestimated hedging rates for small suppliers, and she is wrong to assume that hedges are retained in case of failure (Knott 1, §§106-109). In any event, because the model is not particularly sensitive to the hedging rate, the argument is academic (Knott 1, §§87-88).

98.6. In relation to CCB protection, Dr Hesmondhalgh contends that the IA has overstated the role of the Capital Target in contributing to the protection of CCBs (Hesmondhalgh, §94). Dr Knott explains that the average metric which has been used to quantify this indirect benefit is a reasonable and proportionate one, but that in any event using a lower number for Utilita (or any other small supplier) would not have materially altered the conclusions of the IA (Knott 1, §117-119).

e. <u>Conclusion</u>

99. The Capital Target will contribute to achieving the legitimate objectives set out above. Accordingly, Utilita's first ground of appeal is without merit and should be dismissed.

E. RESPONSE TO GROUND 2: THE LEVEL OF THE CAPITAL TARGET IS REASONABLE

a. Introduction

100. Utilita's second ground of appeal contends that the level which GEMA chose for the Capital Target is based on erroneous calculations, was the result of an arbitrary reduction, and is too high.

101. The Capital Target was set at £115 per customer. This decision was not wrong, and Utilita does not come close to showing it to be wrong. GEMA decided to set the target at a relatively modest level after careful consideration of a range of evidence, including feedback from two consultation exercises (see **section b.** below).

102. The starting point is that GEMA was, in principle, entitled to adopt a common minimum: i.e. to reject, as unsuitable, more complex alternatives to the straightforward per customer measure (e.g. "*targets based on the level of risk actually faced*", NoA §80).[8] The inferiority of Utilita's suggested alternative is discussed under Ground 3 (SECTION F).

103. For present purposes, it is worth noting that Ground 2 is premised[9] on *some* level of Capital Target being appropriate. It follows that Utilita faces a high hurdle. The precise level at which to set the target is not susceptible to a single, 'correct' answer. Rather, this is a quintessential question of judgement for the expert regulator. Given the inherent uncertainties in predicting the likelihood of future events, and that *any* level chosen could be criticised from both directions, the CMA should exercise appropriate restraint.

[8] As discussed further under Ground 3 (see **SECTION F**), GEMA considered more complex policy options, akin to Utilita's preferred alternatives (NoA §80-§81), and concluded they are inferior.

[9] Utilita accepts for the purposes of its arguments under Ground 2 that "*some Capital Target [was] in principle appropriate*" (NoA §70). [Emphasis added].

104. In truth, there is *no* level of Capital Target which Utilita would consider satisfactory.[10] In light of Utilita's financial situation, discussed above ([redacted]), this is not surprising. Dr Hesmondhalgh refers to various figures in her report; without however seeking to suggest any 'appropriate' figure, or range of figures, for the Target.

105. GEMA submits therefore that if Utilita fails, as it must, in arguing that a target at *any* level (above the Floor) is not rationally connected to GEMA's important regulatory objectives (Ground 1) and/or is disproportionate (Ground 3), then Ground 2 goes nowhere. The judgement as to the *precise* level of target that is appropriate to meet the policy objectives is a matter for GEMA unless it has gone materially wrong in its analysis. As set out below, it has not.

106. In sum, GEMA's legitimate, expert decision as to the level of the Capital Target was not outside the range of reasonable decisions open to it, and therefore should not be disturbed.[11]

107. As will become apparent, the arguments which Utilita advances are not entirely consistent on the level of the target. Utilita devotes significant attention to attacking GEMA's decision to <u>reduce</u> the level of the Capital Target, relative to the £145 implied by its analysis of historical losses. At the same time, Utilita argues that £115 is too high. These arguments cut against each other; but in any event, each fails on its merits.

b. <u>Background</u>

108. The process by which GEMA arrived at its Decision on the level of the target was, in summary, as follows:

108.1. In the November 2022 consultation, GEMA proposed that suppliers would be subject to a capital requirement in the range of £110-£220 per customer, with

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[10] Although reference is made (NoA §69 and footnote 88) to a Capital Target of £87 for a customer bill of £2,000, Utilita appears to suggest this would be too *low*, as it is based on an "erroneous" 15% reduction. It does not suggest any concrete alternative to £115, nor any approximate 'range' of figures.

[11] RIIO-2 Energy Licence Modification Appeals 'ELMA 2021' (CMA, 28 October 2021) at §3.79.

the range being closely informed by the level of capital that they are compensated for under the price cap (Hall 1, §61; McPherson 1, §18). It was also proposed that breach of the minimum capital requirement would be a breach of the licence, rendering the supplier subject to enforcement action. At this early stage, the range of potential levels was deliberately wide, for stakeholders' consideration; and GEMA recognised that given market conditions and suppliers' different starting points, it may need to introduce capital requirements in stages. (Knott 1 §60) (McPherson 1 §18) The November 2022 consultation document stated:

"*We are proposing suppliers meet an interim minimum capital requirement by the end of March 2025 of between £110 and £220 per customer, this range being materially lower than the likely level of capital employed under the revised default price cap EBIT allowance … Given current market conditions, we expect the March 2025 requirement to be towards the bottom of the range, but we want to test the implications of higher figures with stakeholders. After this initial period, we would expect to set higher targets…"* **[NOA1/16/245]**

108.2. After careful consideration, GEMA concluded that the timing and level proposed for the capital requirement in the November 2022 consultation, in particular the upper end of the range (£220), "*was too ambitious, given the low starting position"* of suppliers after the recent energy crisis. On the other hand, GEMA was concerned to avoid setting "*an artificially low target"*, in which short-term financing considerations might compromise the objective of longer-term resilience. (McPherson 1 §§20-23)

108.3. As Ms McPherson explains at §44:

"*Had we proceeded with our November [2022] proposals, suppliers would have been required to have up to £220 adjusted net assets per customer by 31 March 2025 or otherwise be in breach of their licence obligations, meaning Ofgem could take enforcement action. Our April proposals, and subsequently our*

Decision, require suppliers to have only positive adjusted net assets to avoid being in breach of the licence condition. We also proposed that our updated Capital Target be set at the lower end of the range included in the November consultation [i.e. £110 - £220 per customer]*, as well as setting on a per fuel rather than per dual fuel customer basis too, to ensure that it was proportionate by avoiding double-counting."* (McPherson 1§44)

108.4. In the April 2023 consultation, after considering a range of evidence, GEMA consulted on its provisional view that a Capital Target of £130 was an appropriate level to meet its regulatory objectives. In arriving at this view:

a. GEMA considered actual EBIT margin profits and losses incurred by suppliers, as a reasonable proxy for the possible impact of shocks on retained earnings (Decision, §§1.17-1.21). This analysis suggested a figure of £145 per customer based on a typical annual bill per customer of £2,000 (reflecting recent wholesale prices at the time of the consultation, but far from the highest levels at which the price cap has recently been set) (Decision, §1.18). **[NOA1/32/691-2]**

b. GEMA's analysis of that historical EBIT data was complemented by its internal analysis of other data points. The figure of £145 was compared to two "*cross-checks*". First, the actual assets of companies. Based on a range of data across the sector, GEMA found a level of fixed assets of approximately £90 per customer on average, though there was a wide range. Giving more weight to the *minimum* levels of capital currently in the market would have run counter to GEMA's policy aims to <u>increase</u> resilience, leaving suppliers vulnerable to shocks. Given the scale of risks to which suppliers are exposed, GEMA considered it was reasonable to set a Capital Target above the average level of fixed assets to create a loss-absorbing buffer (in order to meet its objective of improving resilience). Second, the notional EBIT model was used to compare the historical losses, i.e. £145, to forward-looking losses for a notional supplier. This modelling of risks

suggested that the observed losses were a reasonable guide to the future. **(**Knott 1 Section F §§61-65).

c. GEMA also considered a wide range of qualitative factors (Knott 1, Section F, Table 2). These included the shift to quarterly price caps during the period of observed losses, which it reasonably considered should mitigate short-term losses from rapid changes in wholesale prices. **(**Knott 1 §66, Table 2)

108.5. Overall, GEMA considered that £145 may be an over-estimate of the capital buffer required. Taking the evidence in the round, GEMA reduced the figure by 10% to £130 by April 2023 (Decision, §1.20) **[NOA1/32/692]**.

108.6. GEMA conducted a statutory consultation on its proposed Target of £130 Adjusted Net Assets per domestic dual-fuel customer (£65 electricity; £65 gas) **[NOA1/25/569]**. By proposing to set the Capital Target at £130, considerably below the capital employed under the price cap, GEMA explained in this consultation that it considered the target would be "*robust to a range of different business models"* (Hall 1, §70). Five respondents supported that number; four thought the target was too high; two respondents suggested that the Target should be segmented by supplier business model or set on a supplier specific basis; four did not comment on the number; and a final respondent agreed with the principle but disagreed with the way the number had been calculated (Decision, §§1.10-1.11) **[NOA1/32/690]**. Some respondents, including Utilita, queried the appropriateness of the Target for independent suppliers and the possible impact on competition (Decision, §1.12) **[NOA1/32/690]**.

108.7. GEMA carefully considered the consultation responses and conducted further analysis. As a result, it decided to lower the Target from £130 to £115 per domestic dual-fuel customer (£57.50 gas; £57.50 electricity).

108.8. Before reaching its Decision, GEMA considered a range of quantitative and qualitative factors to arrive at a balanced judgement on the appropriate level of

a market-wide minimum for the Capital Target. It conducted a fresh review of the evidence underpinning the April 2023 consultation (set out above).

108.9. In light of the concerns which had been raised by stakeholders in response to the April 2023 consultation, GEMA gave closer consideration to "*the potential regret risks of setting a target too high*". GEMA also considered that, as this is the first time that the Capital Target is being introduced, it was appropriate to choose a number towards the lower end of the numbers which could have been justified by the supporting evidence; recognising that impacts on consumers and suppliers will be closely monitored, and the target can be revised in due course if appropriate. (Knott 1, §67-71)

108.10. In deciding to reduce the level of the Capital Target from the consulted-on figure of £130 to £115 per customer in the Decision, GEMA further noted that £115 was a common minimum level. It was *"complemented by the eFRP [enhanced Financial Responsibility Principle] requirement that a supplier must have sufficient capital and liquidity for its business specific risks"* (i.e. suppliers with risky business models may well be required to hold capital in excess of the Target) (Decision, §§1.13-14) **[NOA1/32/691]**.

108.11. Finally, in arriving at its Decision, GEMA carried out an Impact Assessment to measure the likely benefits of the Capital Target to consumers. This suggested a net benefit for consumers to introducing the Capital Target, even adopting a conservative approach of estimating the size of benefits, as described in the witness evidence of Gavin Knott. (Knott 1 Sections H-I) GEMA's response to Ground 1 explains the Impact Assessment, and why Utilita's criticisms of it are misplaced (**SECTION D** above). Even on Dr Hesmondhalgh's own analysis (which GEMA does not accept) the Capital Target carries significant net benefits of £250m over the next six years (Knott 1, §78).

c. Response to the ground of appeal

109. Against this background, Ground 2 is wrong for three main reasons:

109.1. **First,** none of the alleged errors in GEMA's methodology withstand scrutiny, for reasons set out in detail in the statement of Dr Knott (at Sections B-E). As noted above, GEMA carried out an analysis of historic EBIT data (i.e. actual losses incurred by suppliers in the relevant time period), in order to inform the amount of capital needed to cover those risks. This implied a base level of £145 per customer. There were no mathematical errors in GEMA's calculations[12] and its analysis is sufficiently reliable to be confident in £145 as the 'base level'. (Knott 1, §26, §33)

109.2. **Second,** Utilita attacks as "*arbitrary"* the decision to lower the Target to £115 per customer, relative to the base level of £145 implied by its analysis of actual EBIT data. This is wrong. GEMA's decision-making process was careful, evidence-based and informed by consultation feedback. Setting the level of the target was an exercise in evaluative, expert judgement, considering a range of quantitative and qualitative factors. The revisions to the target, which were all in the suppliers' favour, took a cautious approach in setting the Capital Target for the first time, at the lower end of what could reasonably be supported by the range of evidence considered. Its decision was reasonable and proportionate.

109.3. **Third**, Utilita argues that the Capital Target is "*disproportionately high*" (NoA §77). The main basis for this criticism seems to be that Utilita disagrees with the choice of time period in GEMA's analysis of the EBIT data (NoA §66, footnote 86). That criticism is wrong for reasons explained below, so this point falls away. In any event, the disproportionality argument lacks merit. As explained above, GEMA has set the target at a relatively modest level.

110. As to the **first** point, GEMA's evidence deals in detail with Utilita's criticisms of its analysis of the EBIT data and the resulting base level figure of £145. (NoA §66-67) (Knott 1, Sections B-E) Each criticism is misplaced. In summary:

[12] As Gavin Knott explains in his statement at §34, there was a typographical error in the April 2023 statutory consultation, which was corrected in the Decision at §1.18. **[NOA1/32/691]**

110.1. There were no material errors in GEMA's calculation of the £145 figure (contrary to NoA §67). As Dr Knott explains in his statement at §34, there was a typographical error in the April 2023 statutory consultation, which is corrected in the Decision at §1.18. **[NOA1/32/691]**

110.2. Utilita suggests that Dr Hesmondhalgh's analysis produces "*a different result*" to GEMA's in terms of the base level. (NoA §67) It is notable that this criticism depends on Utilita demonstrating that the base level should be <u>higher</u> than GEMA had calculated (£184 rather than £145). However, when Dr Hesmondhalgh's data set is properly analysed, it implies a base level very similar to GEMA's: the "*true comparison*" is £150 versus £145. In any event, the differences are based not on errors in GEMA's analysis, but on the use of alternative measurement approaches, and are not as significant as Utilita contends. **(**Knott 1, §32-33)

110.3. Dr Hesmondhalgh makes adjustments to this base level figure which are unpersuasive, as explained in detail in Dr Knott's statement. She excludes certain losses in ways which are subjective and not robust. **(**Knott 1, §40) As such, Utilita's criticism of the EBIT data as reflecting "*supplier-specific idiosyncratic risks*" (NoA §66.1) is misconceived.

110.4. Dr Hesmondhalgh also highlights differences between risks faced by suppliers. While recognising that there are some differences in suppliers' risk levels, GEMA has accounted for this: that was one of the qualitative considerations behind its decision to significantly lower the level of the target. **(**Knott 1, §66 Table 2) Contrary to Utilita's case, it is clear that GEMA had regard to this factor in concluding that £115 is an appropriate common minimum. (NoA §68).

110.5. Finally, Utilita criticises the time period chosen by GEMA for its analysis of the EBIT data (in both Ground 2 and Ground 3: §66 and §77). Dr Knott explains, in his evidence, that the time period chosen was "*the most representative time*

period compared to where we are now, with a range of suppliers of different sizes and business models". He explains that: (Knott 1, §46-47)

a) Older time periods would have produced "*much less useful results*", for reasons including the mix of suppliers in the market now (and expected in future) as compared to ten years ago,

b) In any event, adding six years to GEMA's time period does not materially impact the output.

110.6. In sum, none of Utilita's criticisms demonstrate that GEMA's analysis was wrong. On the contrary, GEMA's analysis is sufficiently robust to support £145 as a reasonable data point in setting the level of the target. Nor, as explained above in **section b**, was this analysis the only source of evidence which GEMA considered in arriving at its Decision.

110.7. Put at its highest, the report of Dr Hesmondhalgh merely provides further support for GEMA's decision, in an exercise of regulatory judgement, to set the Target at a lower level than the figure of £145. **(**Knott 1, §45)

111. **Second**, the Decision to lower the level of the target at £115 was not "*arbitrary*" (NoA §68). As set out in the chronology at **section b** above, GEMA decided to set the target at the lower end of what its evidence could support, i.e. at a relatively modest level, after analysing a range of quantitative and qualitative factors, and having regard to feedback from two consultations (§108). GEMA's decision-making process was evidence-based, and its revisions to the target were all in the suppliers' favour.

112. GEMA has been clear that *"there is no 'perfect number'"* (Decision, §1.21) **[NOA1/32/693]** but that £115 was a reasonable level for the Target. GEMA further accepts that there are uncertainties: this is inevitable given that it is setting a Capital Target for the first time. Moreover, there is no precise way to measure the level of the Capital Target; no single 'correct' figure. All of this helps to explain why "*Ofgem used*

a cautious approach and set the target at a level below the numbers indicated by the model [i.e. £145]". **(**Knott 1 §54)

113. Dr Knott further explains that Dr Hesmondhalgh's review of GEMA's analysis "*is focused only on those elements that could result in a lower number"*. But other stakeholders criticised GEMA's analysis for resulting in a target which is too low. This serves to illustrate the real need for caution on the CMA's part before interfering with the balance which GEMA has struck in setting the level of the target. **(**Knott 1, §55)

114. Recognising that there are uncertainties, and accepting (as is the necessary premise of Ground 2) that a target needs to be set at *some* level, any figure chosen could be criticised as 'arbitrary'.

115. **Third,** Utilita's criticism that the target has been set "*disproportionately high*" mischaracterises GEMA's analysis. This argument rests on Utilita showing that GEMA's chosen time period (2016-2022) was a clear error of analysis.

116. This point is raised first under Ground 2, then repeated in Ground 3 (NoA §66, §77). The criticisms by Utilita of GEMA's chosen time period are wrong for the reasons explained above. (§110.5) **It** follows that its argument that the base level of £145 is skewed by the time period and, thus, 'too high' must fail. (NoA §77)

117. Since Utilita's arguments about the time period fail, its 'disproportionality' critique inevitably fails as well. Without prejudice to that, GEMA submits that in any event, Utilita is wrong to suggest that the level at which the target was ultimately set is outside the bounds of reasonable regulatory judgement or is disproportionate to the goal of resilience. On the contrary, as explained above, GEMA has reduced the Capital Target significantly; the target is much lower than the £145 implied by its analysis of historical EBIT data, and at the lower end of the range which its evidence could reasonably support. (See **section b)**. Contrary to Utilita's arguments (NoA §68.2), GEMA has also had specific regard to the possibility that some differences in suppliers' risks may have affected the historic losses and thus that £145 may be an over-estimate. It has already

accounted for that by reducing the level of the target. **(**Knott 1, Table 2) (Churm 1, §§60-69)

118. Though it is not required to do so, it is notable that Utilita suggests no alternative 'reasonable' figure, or even an approximate 'reasonable' range for the Target, to compare against £115 per customer. In truth, Utilita regards *any* Capital Target as 'too high'.

119. Overall, the careful process GEMA followed to arrive at a reasonable judgement belies Utilita's arguments (NoA §77). GEMA's decision that £115 was an appropriate and proportionate level to meet its regulatory objectives has not been shown to be wrong, not least because falling below the Target is simply a trigger for a plan for increasing capitalisation over time (Decision, §1.21) **[NOA1/32/693]**.

d. <u>Conclusion</u>

120. Overall, GEMA's judgement to set the Capital Target at the level chosen in its Decision was well within the margin of appreciation afforded to the expert regulator. As set out above, this is exactly the sort of decision which calls for restraint by the CMA; recognising that *any* level would be open to criticism from both directions. Indeed, £115 per domestic dual-fuel customer has been criticised as both too high and too low (§113), including by Utilita itself (NoA §68, §77).

121. For the reasons explained above, the second ground of appeal is without merit and should be dismissed.

F. <u>RESPONSE TO GROUND 3: THE CAPITAL TARGET IS DISPROPORTIONATE</u>

a. Introduction

122. Utilita's third ground of appeal is that GEMA failed to have regard to certain regulatory principles in developing the Capital Target and associated compliance framework; or failed to give them appropriate weight.[13] (NOAMS/71).

123. Section 4AA(5A) GA86 and section 3A(5A) EA 89 provide that in carrying out its functions, GEMA must "*have regard to*" the principle that regulatory activities should be "*proportionate*" and "*targeted only at cases in which action is needed*" (**"the Principles**").

124. To succeed on this ground Utilita must, in effect, persuade the CMA that the *only* way GEMA could give proper weight to the Principles is either <u>not to impose</u> a Capital Target; or to <u>remove the associated compliance framework</u>. On Utilita's case, a Capital Target *at any level*[14] gives insufficient weight to the Principles (to proportionality in particular): because of the allegedly "*severe*" consequences of the compliance framework, and/or because there are (in Utilita's view) 'better' alternatives to a common minimum target.

125. To summarise GEMA's submissions on this ground, it is without merit. Utilita misinterprets key features of GEMA's Decision—the interaction with the eFRP and the "Intermediate Position" in particular, which is not "one-size-fits-all". Further, it is clear that GEMA *did* have regard, and gave proper weight to, the Principles in the process of developing the Capital Target, and the compliance framework in particular. In short, GEMA decided the policy was reasonably necessary in order to achieve its objectives, in particular improving resilience; and was not disproportionate, in particular due to the flexibility built into the compliance framework: see further the witness statement of

[13] Section 11E(3)(b) EA 89.

[14] Utilita's sub-argument under Ground 3 (NOAMS/77) that the <u>particular</u> level at which the Capital Target has been set (£115) is disproportionately high and outside the "*scope of any margin of discretion or judgement*" have already been addressed under Ground 2.

Megan McPherson, discussed below (McPherson 1). Utilita provides no warrant to interfere with this conclusion.

126. As to Utilita's (tentatively suggested) alternatives to the Capital Target (NoA §80-81), GEMA considered and rejected such complex permutations. Its reasons for doing so were evidence-based and reasonable. This issue is considered in detail in the witness statement of Rohan Churm (see further below) (Churm 1).

b. Background

127. The detailed background to the Capital Target is set out in GEMA's witness evidence. This section focuses on Utilita's argument that GEMA failed to have regard/give weight to the Principles in developing its policy, and the compliance framework in particular. Ground 3 criticises the compliance framework as "*severe*".

128. This argument is unsustainable, in light of the history of the policy. This issue is dealt with in the witness statement of Ms McPherson, Head of Capital Adequacy Policy and Strategy at Ofgem. GEMA highlights the following key points:

128.1. The compliance framework was developed by GEMA in response to feedback from its November 2022 Statutory Consultation, which had consulted on a capital requirement in the range of £110-£220. After this consultation, GEMA devised the mechanism of the Capital Floor and Target, with an Intermediate Position in between. (McPherson 1, "Background to the compliance framework") (McPherson 1, §17)

128.2. Ms McPherson explains (McPherson 1, §19): "*Being below the Target is not a breach of a licence condition… I emphasise this because it is important for understanding how much more flexible the final compliance framework is than what we proposed in November 2022 and therefore how much consideration we gave to the need to be proportionate and targeted and to have the ability to reflect individual supplier circumstances in our decision-making.*" [Emphasis added]

128.3. GEMA recognised that setting a common minimum standard has disadvantages. GEMA's chosen framework aimed to address such risks by setting a modest Capital *Floor* (zero) which all suppliers should be able to meet, and of which Utilita makes no criticism in this appeal. Further, the framework in GEMA's Decision allows, where the Capital *Target* is not met, regulatory flexibility as to the time and method of recapitalisation. (McPherson 1, §14).

128.4. The objective of the compliance framework (and the Intermediate Position specifically) is to allow licensees to use the Target as a "*loss-absorbing buffer*" in times of stress but to have strong incentives and controls to ensure that they are not below the Target indefinitely. This framework allows the licensee and the regulator time to take remedial action to improve financial resilience, or take steps towards an orderly market exit if needed. (McPherson 1, §12-13).

128.5. Following its November 2022 Statutory Consultation, GEMA took further considerable steps to ensure its policy struck an appropriate balance between its aim for "*simplicity in our policy design to make it easier to implement and enforce"*, and the disadvantages of simpler options (e.g. a single common minimum capital requirement of £110) – *"namely that it would be less accommodating to diverse business models"* (McPherson 1, §23) . It took a number of steps, notably developing the Capital Floor and Target framework, and reconsidering its definition of capital. (McPherson 1, §24-36).

128.6. In developing "Transition Controls" for suppliers falling below the Target, GEMA continued to have close regard to the principle of proportionality. As Ms McPherson explains, "*In choosing which controls should apply by default, we thought carefully about what was proportionate i.e. which controls would not only incentivise a supplier to recapitalise and improve resilience, but also help them to do so in most circumstances …. We also decided that these automatic controls would not apply"* where the supplier put in place a credible Capitalisation Plan: "*This will ensure that the measures in place while a supplier is below the Target remain proportionate, as well as ensuring that there*

was an incentive to complete a plan in a timely manner…" (McPherson 1, §39-40).

128.7. Accordingly, in its April 2023 Statutory Consultation, GEMA proposed that suppliers maintain a Capital Floor of £0 Adjusted Net Assets per customer and meet a Capital Target equivalent to £130 Adjusted Net Assets per dual fuel customer, both from 31 March 2025. Not meeting the Floor would be a breach of the licence; not meeting the Target would require suppliers to submit a credible Capitalisation Plan, and they would be subject to default Transition Controls until they had done so. GEMA sought feedback on its proposal. (McPherson 1, §42).

128.8. After the April 2023 Statutory Consultation, GEMA again had regard to the Principles, in light of consultation feedback. GEMA *"focused on whether we had got the balance right between providing flexibility while maintaining the robustness of the capital requirements… <u>with a view to ensuring that the overall framework was proportionate and reflective of different business models and suppliers' starting positions, while still achieving our objectives</u>. To do this we looked again at the level of the target … Alternative Sources of Capital and the Intermediate Position process."* Stakeholders' views were considered closely. Having considered its overriding duties to act in the interests of consumers, GEMA concluded that its framework was sufficiently flexible. (McPherson 1, §46-47).

128.9. As part of this, GEMA carefully considered some specific issues now raised by Utilita in Ground 3, such as the proposal for a 'deadband' and the argument that Transition Controls could harm a supplier's efforts to recapitalise (McPherson 1, §49-52).

128.10. Overall, GEMA concluded "*there was not a case to change the compliance framework substantively from our April proposals"* but they gave clearer Guidance and clarification to suppliers. GEMA decided it had broadly struck

the right balance between flexibility for different business models, while scrutiny and controls would hold suppliers to account. (McPherson 1, §53).

128.11. As Mc McPherson notes, and is apparent from the forgoing, GEMA had careful regard to the Principles throughout the process of policy development, resulting in significant changes to its policy design on compliance:

"*It is worth summarising the impact of the changes from the November proposals to the April proposals to emphasise the extent to which we have had regard to our interventions being proportionate, targeted and financeable. It also helps to explain why, in light of these adjustments, we think it is reasonable that suppliers in the Intermediate Position should be subject to additional Transition Controls. Had we proceeded with our November proposals, suppliers would have been required to have up to £220 adjusted net assets plus alternative sources of funding per customer by 31 March 2025 or otherwise be in breach of their licence obligations, meaning Ofgem could take enforcement action. Our April* [2023] *proposals, and subsequently our Decision, require suppliers to have only positive adjusted net assets to avoid being in breach of the licence condition. We also proposed that our updated Capital Target be set at the lower end of the range included in the November consultation, as well as setting on a per fuel rather than per dual fuel customer basis too, to ensure that it was proportionate by avoiding double-counting*." (McPherson 1, §44).

c. <u>Response to the ground of appeal</u>

129. To a significant extent, Utilita's third ground of challenge simply repeats points made under Grounds 1 and 2: see NOAMS/ 76,77,78 (second sentence) and 82.

130. Leaving the repetitive points to one side, the main arguments under Ground 3 are:

130.1. **The Intermediate Position** (NOAMS/78 and 83): Utilita criticises the consequences for those falling below the Capital Target as "*severe*". But Utilita mischaracterises the flexible and supplier-specific compliance framework

which GEMA has devised, which strikes a careful balance between allowing suppliers flexibility to re-capitalise on the one hand, and achieving GEMA's important policy objectives, on the other. Once the regime is properly understood, and in light of the history above (**section b**), it is clear that GEMA *did* have regard, and gave amply sufficient weight, to the Principles.

130.2. **Alternatives to the Capital Target** (NOAMS/80-81)**:** Utilita suggests that *a common minimum* target of *any level* is unnecessary/unreasonable in light of alternatives. Utilita does not however demonstrate why the common minimum is 'wrong', nor are the alternatives it suggests clearly superior. Utilita's acceptance, in principle, of the Capital Floor (£0 Adjusted Net Assets per customer) is important: this undermines Utilita's contention that a 'common minimum' approach can never be justified in principle. Despite its arguments under Ground 3, it is not Utilita's case that it was inappropriate for GEMA to set the Capital *Floor* at the same level for all suppliers (see Ground 1, **SECTION D**, §§75-76). In any event, GEMA considered and rejected more complex options as inferior to the Capital Target in terms of achieving its regulatory objectives, and/or as unworkable; informed by the principle of proportionality in doing so. That decision is not 'wrong'.

131. The proper context for these arguments is as follows.

132. The Court of Appeal held in *R (Pharmaceutical Services Negotiating Committee and anor) v Secretary of State for Health* [2018] EWCA Civ 192, [2019] PTSR 885:

132.1. At §82: "*it is well established that any consideration by the court of compliance with a duty to "have regard" to a particular factor involves a review of the process and not the merits*".

132.2. And, at §84: "*The weight, if any, to be given to relevant factors in such circumstances is thus essentially a matter for the public body assigned by Parliament to make the relevant decision; and the courts have emphasised the importance of not imposing too high a burden on such decision-makers*".

133. The CMA has made clear that its starting point "*should not be to determine whether there is an alternative approach and then decide whether it is better. We should only determine whether there is an error in the approach chosen by GEMA, as alleged by the appellants".* (**ELMA 2021,** vol 1, §3.40).

134. Thus, the first question for the CMA is whether GEMA had proper regard to the Principles in its decision-making process,. The answer is, clearly, 'yes'. As **section b** above makes clear, in developing the Floor and Target mechanism and associated compliance framework, the need for regulatory intervention to be proportionate and targeted was carefully considered throughout. The policy struck a careful balance, and is a reasonably necessary and appropriate means of meeting GEMA's policy objectives.

135. The second question is whether GEMA gave appropriate weight to the Principles, in particular, in rejecting more complex alternatives which Utilita might prefer (NoA §80-81). In considering this, the CMA will not substitute GEMA's assessment or weighing of the evidence or reasoning with its own "*unless we are satisfied that GEMA's approach was wrong – for example, because there was a clearly superior alternative approach".* (ELMA 2021, vol 1, §3.77 and §3.42). [Emphasis added][15]

136. Against this background, GEMA's response to Utilita's two main arguments is as follows.

137. As to the allegedly "severe" consequences of the **Intermediate Position**:

137.1. Ms McPherson's statement makes clear that Ofgem gave careful, and appropriate, consideration to the key regulatory Principles. GEMA struck a

[15] GEMA notes that Utilita cites two human rights cases under Ground 3. GEMA respectfully submits that the relevance of these cases to the present context is limited. Without prejudice to that position, GEMA observes that in R (Tigere) v Secretary of State for Business, Innovation and Skills [2015] UKSC 57; [2015] 1 WLR 3820, a human rights case concerned with justification for discrimination under Article 14 ECHR (decided by a 3-2 majority of the Supreme Court), the majority declined to give deference to the Secretary of State's judgement because he had not addressed his mind to the allegedly disparate impact when making the impugned Regulations (paragraph 32). By contrast to that case, GEMA has had careful and appropriate regard to the Principles in developing its policy, including considering Utilita's consultation responses. Tigere does not apply.

balance "*between providing enough flexibility to accommodate different business models, while providing enough scrutiny and controls to ensure we could hold suppliers to account.*" (McPherson 1, §53).

137.2. Utilita's argument is premised on a misunderstanding of the consequences of being in the Intermediate Position. It is correct that a failure to comply with the Capital Target has regulatory consequences. But Utilita overstates the position. The default Transition Controls, against which this part of the challenge is primarily directed, will only apply where a supplier falls below the Capital Target and does not have a credible Capitalisation Plan in place. Suppliers can avoid the default Transition Controls by acting early to build a path to appropriate capitalisation and having a credible plan in place. (McPherson 1, §52)

137.3. The path to appropriate capitalisation may require additional equity or long-term debt to be raised. This may not be in the interests of the existing shareholders, but that is very different from what is necessary and appropriate in the public interest and the long-term interest of the supplier itself.

137.4. Thus the compliance framework cannot properly be characterised as "severe". But even if it were, GEMA's Decision cannot be impugned as having been taken without regard, or without appropriate weight, to the Principles. The compliance framework is reasonably necessary to achieve GEMA's policy objectives, especially resilience, as Ms McPherson explains. Although significant flexibility has been allowed, it was important: "*to have strong incentives and controls to ensure that they* [licensees] *are not below the Target indefinitely … if the compliance framework was too flexible, i.e. if there was little differentiation between being above or below the Target, then we risk creating an unlevel playing field where some licensees could gain a competitive advantage and/or losses from suppliers are more likely to fall on consumers or the taxpayer. Suppliers need to prioritise compliance with the Capital Target…*". (McPherson 1, §15)

137.5. The capital requirement is comprised of a common minimum (the Floor and the Target) and the eFRP requirement to have sufficient capital and liquidity to cover business specific risks. This framework means that riskier suppliers will be required to have more capital that the common minimum. (McPherson 1, §65)

137.6. Finally, it is clear that GEMA has afforded significant latitude as to how, when and in what way recapitalisation is achieved. This framework was designed "*precisely to ensure*" that GEMA could "*take account of supplier's specific circumstances and ... accommodate diverse business models*". (McPherson 1, §9) The deadline for the plan, the path to the Capital Target, and the nature of any controls on capital leaving the business and growth strategies can be tailored to the supplier. (Indeed, some stakeholders were concerned about the extent of flexibility and if GEMA would use this discretion to be too lenient). (McPherson 1, §60 §47).

137.7. As Ms McPherson explains, "*While the Capital Target is not targeted in the sense of being supplier specific, the Compliance Framework and the interaction between the enhanced FRP and common minimum requirement have been designed precisely to accommodate diversity of business models but in a way that still enables us to achieve our core objective of capitalising the sector to become appropriately resilient*". (McPherson 1, §57)

138. As to its second argument, alleged **Alternatives to the Capital Target**: Utilita contends that a Capital Target *at any level* is disproportionate and/or clearly inferior to alternative options, on the basis (Utilita argues) that "*suppliers actually face very different types and levels of risk depending upon their business model.*" (NOAMS/81).

139. This complaint has two prongs.

140. **<u>First</u>**, Utilita argues that there is <u>no</u> basis for common capital requirements. This ambitious argument is wrong, for the reasons explained in GEMA's evidence, in

particular the witness statement of Mr Churm, GEMA's Interim FRC Director, who has over 20 years' experience at the Bank of England:

140.1. Mr Churm explains why a common minimum capital buffer meets the consumer interest of increasing resilience. The Capital Target thus fulfils GEMA's policy objectives to "*build the recapitalisation of the sector, enhance resilience to external shocks and put the retail market on a solid foundation to deliver the innovation, high standards and consumer outcomes needed to achieve our principal objective: protect the interests of existing and future consumers.*" (Churm 1, §13).

140.2. It does so in two ways: (i) directly, by creating a 'buffer' and (ii) indirectly, by increasing "skin in the game", shifting the balance of risk from the consumer onto the shareholder. (Churm 1, sections A3 and A4).

140.3. It is clear that suppliers face common risks. GEMA's stress tests showed that almost all suppliers were weakest under a scenario of simultaneous price and demand shock. While performance in response to such stressors varied with supplier business models, the risk of simultaneous price and demand shock was common across the sector. (Hall 1, §24).

140.4. The witness evidence of Dr Knott further rebuts Utilita's contentions, under Ground 3, that there is no basis for a common minimum. On the contrary, Dr Knott explains: *"The majority of risks to an energy supplier are common to all suppliers. While some of these risks have different mitigations depending on business models and risk management practices, residual risk will remain."* (Knott 1, §17).

140.5. Thus, GEMA considered there to be real value in having clear minimum standards, as part of a flexible and risk-sensitive approach to regulation; this decision was supported by the evidence and falls well within the bounds of regulatory discretion. As Ms McPherson notes, this decision was made giving appropriate weight to the relevant regulatory Principles: "*Of course, there is a*

perennial issue in all regulation as to the benefits and disadvantages of clear rules applying across an industry versus case-by-case flexibility, but GEMA is well aware of that issue and sought to reflect a proper balance in its decision making. While it is inevitable that some suppliers and other stakeholders would have preferred to strike that balance differently, it does not make GEMA's decision wrong." (McPherson 1, §16)

140.6. Indeed Utilita's own financial position provides an illustration of a need for these measures [redacted]

141. **Second**, Utilita argues that the Decision as to the Capital Target policy gave insufficient regard/ weight to the principle of proportionality in view of alternative more nuanced policies which Utilita might prefer. These alternatives are:

141.1. NOAMS/80.1: "*targets based on the level of risk actually faced*".

141.2. NOMAS/81: a target set as a percentage of risk-weighted assets.

141.3. NOMAS/83: a "*deadband or flexibility*" to respond to the alleged problem of "*a supplier needing to repeatedly issue and seek approval for capitalisation plans*".

142. This point must fail in circumstances where GEMA has considered and rejected more complex permutations of its policy, on perfectly reasonable grounds:

142.1. GEMA has set a target based on the level of risk faced, as it considers there are common residual risks. GEMA considered the impact of different payment types, and different tariff types, on capital requirements and concluded that these differences had more bearing on working capital needs than loss-absorbing capital. Overall, for the reasons set out in Mr Churm's statement, GEMA did not consider that a different loss-absorbing buffer for different payment types was appropriate. (Churm 1, §60-69, Knott 1, §92; McPherson 1 §66).

142.2. As Mr Churm's statement explains, there are appreciable benefits of "*straightforward implementation of the Capital Target as a £ per customer measure*", both for suppliers and GEMA (Churm 1, 57). This draws on evidence from the banking sector and the energy crisis itself, that points against "*more complex implementation*". GEMA considered, but rejected, a more complex approach such as that Utilita prefers; "*because the complexity they would introduce would increase costs to suppliers (and ultimately consumers) without an increased benefit, and ... there remained a clear case for a common minimum capital requirement for all to mitigate the common risks*". (Churm 1, 59).

142.3. GEMA also considers that the majority of sources of risk are invariant to customer payment type and that the requirement for a loss absorbing capital buffer is not comparable to the price cap payment type differentials. (Churm 1, §67).

142.4. The complaint that there is "*no deadband or flexibility*" for when the supplier briefly 'dips' below the Capital Target (NoA, §83). This criticism is not made out. GEMA considered a 'deadband' and rejected it, for reasons explained in its Decision, at §3.13 (NOA1/32/718): "*This would introduce further complexity and uncertainty into the process and may effectively result in a reduction of the Target, without clear evidence that this would be justified in practice.*" GEMA also made clear in its Decision at §3.12 that Capitalisation Plans could take multiple fluctuations into account to avoid the need for multiple plans (NOA1/32/718).

143. For completeness, although most of Utilita's arguments under this Ground are addressed under Grounds 1 and 2 above, in summary GEMA's responses to each point made are as follows

143.1. The first argument is that there is no rational connection between the measure and the legitimate objective it serves, and so it is necessarily disproportionate

(NOAMS/76). This adds nothing to Ground 1 and it fails for the reasons already explained in relation to that Ground (see **SECTION D** above).

143.2. The second argument is that the level of the Capital Target is both arbitrary and unnecessarily and disproportionately high (NOAMS/77). This ground is closely linked to Utilita's challenge on Ground Two and it fails for the same reasons (see **SECTION E** above).

143.3. The third argument is that the consequences for suppliers of falling into the Intermediate Position are severe (NOAMS/78). This argument is based on a mischaracterisation of the regime but in any event fails on its own terms for the reasons explained above (see paragraph §137 above).

143.4. The fourth argument is that GEMA has adopted a "one-size-fits-all" approach (NOAMS/79) and that, because Utilita would prefer different, more complex policy options to be chosen, therefore GEMA's approach is disproportionate. This criticism is misplaced, for the reasons addressed above (paragraphs §§137- above).

143.5. The fifth argument is that the price cap "*makes the retaining of profits to build up capital impossible*" (NOAMS/82). This argument goes nowhere. Utilita's complaints about the price cap are misconceived (see above SECTION D). This is covered in detail in Mr Churm's statement (Churm 1, §86-96) but to summarise here, It is therefore reasonable to conclude that a hypothetical PPM supplier is able to make a profit under the price cap and earn a return on the capital required to use as a capital buffer. Further, as set out above, the compliance framework allows for suppliers to meet the Target in method and at the pace that is suitable for their business model.

143.6. The sixth argument is a complaint that there is "*no deadband or flexibility*" for when the supplier briefly 'dips' below the Capital Target (NOAMS/83). This argument is responded to immediately above. (see paragraph §.4 above).

d. **Conclusion**

144. For the reasons explained above, the third ground of appeal is wholly without merit and should be dismissed.

G. <u>CONCLUSION</u>

145. For the reasons set out above, GEMA respectfully submits that the appeal should be dismissed.

BEN JAFFEY KC

NATASHA SIMONSEN

RACHEL JONES

Blackstone Chambers

12 October 2023

H. STATEMENT OF TRUTH

GEMA believes that the facts stated in this Response are true. I am duly authorised to sign this statement on behalf of GEMA.

Signed:

Name: David Hall

Position: Deputy Director of the Financial Resilience and Controls Policy

Dated: 12 October 2023