

**APPLICATION FOR PERMISSION TO INTERVENE IN ENERGY LICENCE
MODIFICATION APPEAL**

OVO ENERGY LIMITED

NOTICE OF INTERVENTION

- 1 This is an application by OVO Energy Limited (**OVO**) – acting on behalf of the relevant licence holders, OVO Electricity Limited and OVO Gas Limited¹ – to the Competition and Markets Authority (the **CMA**) for permission to intervene in support of the energy licence modification appeal (the **Appeal**) brought by Utilita Energy Limited (the **Appellant**) against the decision of the Gas and Electricity Markets Authority (**GEMA**²) dated 26 July 2023 to modify standard licence condition (**SLC**) 4B pursuant to section 11A(1)(b) of the Electricity Act 1989 (**EA89**) (in respect of electricity supply licences) and section 23(1)(b) of the Gas Act 1986 (**GA86**) (in respect of gas supply licences) to, inter alia, introduce a new Capital Target for gas and electricity suppliers (the **Decision**).
- 2 On 21 September 2023, the Appellant was granted permission to appeal against the Decision on the following grounds:
- (a) Ground 1: The Capital Target does not Achieve the Effect Stated by the Authority;
 - (b) Ground 2: Errors in Setting Capital Target; and
 - (c) Ground 3: Disproportionality of the Capital Target and the Associated Compliance Framework.
- 3 OVO has considered the Appellant’s main submission (the **NOA**) and witness and expert evidence, including the report by Dr Serena Hesmondhalgh (**Hesmondhalgh 1**), in support of its NOA and wishes to intervene in support of the Appellant on all three of the closely related grounds pleaded.
- 4 OVO Electricity Limited and OVO Gas Limited are licensed retail suppliers of gas and electricity in Great Britain and, as such, are materially interested in the outcome of the Appeal. As relevant licence holders (within the meaning of section 11A(10)(a) EA89 and section 23(10)(a) GA86)

¹ OVO Electricity Limited and OVO Gas Limited are wholly owned by OVO Energy Limited and are - as at the date of OVO making this application to intervene - the relevant licence holders under sections 6(1)(d) and 7A(1) of the Electricity Act 1989 and the Gas Act 1986, respectively. However, OVO Energy Limited submitted applications for an electricity supply licence and a gas supply licence to Ofgem on 29 August 2023 and these are currently under consideration. Going forward, the intention is for OVO Energy Limited to be a licensed entity for both gas and electricity. For completeness, OVO (S) Electricity Limited and OVO (S) Gas Limited currently also hold relevant supply licences, but are legacy SSE entities that are being sunsetted and no longer have any customers.

² GEMA is supported by the Office of Gas and Electricity Markets (**Ofgem**). OVO refers interchangeably to GEMA, the Authority and Ofgem in this document, depending on the context.

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- they are directly affected by the Decision.
- 5 OVO recognises that it could have applied for permission to appeal the Decision in its own right. However, in the period immediately following the publication of the Decision, OVO was focused on conducting a detailed analysis of the impact of the Decision and engaging at the most senior levels within Ofgem to highlight the material adverse consequences that arise from the Decision.
- 6 OVO requests that the CMA grant it permission to intervene as it has material additional argument and evidence that will assist the CMA to determine the Appeal. Recognising the need to be additive, in particular given the tight timeline of the Appeal, OVO's additional evidence focuses on how the flawed cost-benefit analysis in Ofgem's Revised Impact Assessment of Strengthening Financial Resilience proposals and accompanying model (the **Impact Assessment**) has led GEMA to overestimate the alleged customer benefits and underestimate the costs of the Capital Target. It also highlights material flaws in Ofgem's assessment of the impact of the Capital Target on competition, including Ofgem's failure to adequately take into account the negative impact the Capital Target will have on competition and innovation. This supports arguments made by the Appellant in Ground 1 of its Appeal, and in particular at §§55-59 and 61. OVO's evidence also sets out the effect that the Capital Target would have on OVO, which supports in particular arguments made by the Appellant at §§60, 78 and 82 of its Appeal.³
- 7 In preparing this notice of intervention, OVO has sought not to duplicate points made by the Appellant, not to create a proliferation of documents or evidence, and has been mindful of its duty as an intervener to assist the CMA to further the overriding objective (as per Rule 4.2 of the Energy Licence Modification Appeals: CMA Rules (CMA70) (the **CMA Rules**)). In addition, OVO has liaised with the Appellant in relation to this application in order to reduce cost, delay and duplication as far as possible. In these circumstances, OVO considers that it would be proportionate for the CMA to grant it permission to intervene.
- 8 OVO's substantive arguments on the Appeal and the facts and reasons on which it relies are contained in this short notice of intervention, the factual evidence in the first witness statement of Vincent Francis Casey, Chief Financial Officer at OVO, dated 12 October 2023 (**Casey 1**), the economic expert evidence of Mary Starks, partner in Flint Global's Competition and Regulation practice (**Starks 1**), and accompanying exhibits.
- 9 If OVO is granted permission to intervene, OVO would wish to participate actively in the Appeal. OVO envisages that such intervention would include: (a) responding to any requests for information from the CMA; (b) attending the main party hearing primarily in an observer capacity but with the opportunity to make oral representations on the evidence given by the main parties; and (c) reviewing and providing written submissions on the CMA's provisional determination (including any proposed remedy). OVO intends that its intervention be 'business-led' but

³ This summary is designed to assist the CMA; OVO notes that there are interlinkages across the arguments made by the Appellant and by OVO.

confirms that it would be willing for its external advisers to join any confidentiality ring put in place by the CMA to facilitate the CMA's process.

OVO'S SUBSTANTIVE ARGUMENTS IN SUPPORT OF THE APPELLANT'S GROUNDS OF APPEAL

10 OVO supports all three of the grounds of appeal pleaded by the Appellant based on the facts and reasoning set out below. However, OVO's application for permission to intervene will focus on Grounds 1 and 3, where it considers its input is most additive and likely to assist the CMA. In relation to Ground 2, OVO are supportive of the arguments of Utilita and the findings in Hesmondhalgh 1.

11 As described at §53 of the NOA, the Capital Target is designed, among other things, to reduce supplier failures and the risk of mutualising costs of such failures to consumers. However, as consistently submitted to Ofgem, and as set out in more detail in Casey 1, OVO is concerned that the Capital Target will lead to a significant decline in the resilience of many retailers in the sector and will have a negative impact on competition and innovation, to the detriment of consumers.

12 Specifically, OVO considers that the Decision to introduce the Capital Target rests on a flawed cost-benefit analysis in the Impact Assessment. The Impact Assessment significantly overstates the benefits arising from the introduction of the Capital Target and does not properly engage with the significant costs that the Capital Target will result in. When these errors are corrected, the very small consumer benefit that GEMA considers that the Capital Target will have is completely wiped out and, instead, analysis shows that the Decision will do more harm than good. Absent delivering consumer benefit, it is impossible that the Capital Target will achieve its stated objective (the Appellant's Ground 1) and it follows that its introduction would be disproportionate and not in the interests of consumers (the Appellant's Ground 3).

13 OVO consistently highlighted these concerns with the Impact Assessment work to Ofgem during the consultation process and offered to support the regulator with modelling the impact of the Capital Target on suppliers. However, as explained in Casey 1, Ofgem failed to properly engage with OVO's concerns, such that the Decision remains flawed.

14 [REDACTED]
[REDACTED]
[REDACTED] As the Capital Target is for no benefit, impedes effective competition, and could lead to the exit of otherwise financially resilient suppliers (in turn leading to worse outcomes for consumers), it must be the case that the Appellant's appeal should succeed.

Ground 1: The Capital Target does not Achieve the Effect Stated by the Authority

15 In the Impact Assessment, Ofgem erroneously concludes that the implementation of the Capital

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Target will result in a small customer benefit averaging £1.80 per year for each affected customer over a 6-year period. In fact, as more fully described in Casey 1, when Ofgem's Impact Assessment model is updated to correct for the errors identified by OVO, it shows the Capital Target will instead lead to net detriment of £-0.09 per year for each affected customer.

- 16 The detail below and in Casey 1 as to the nature of these errors are additional to and support the Appellant's argument in §61 of the NOA that Ofgem's conclusion that the Capital Target will deliver positive consumer outcomes is unsupportable, and as such is contrary to its stated objectives.

Overestimation of possible benefits

- 17 The perceived benefit of the Capital Target – namely, reducing the risk of mutualising costs of supplier failures – can be broken down into two main elements: (i) reducing the probability of supplier failure; and (ii) limiting the impact of supplier failure. Both of these elements are erroneously addressed in the Impact Assessment.
- 18 First, the Impact Assessment fails to sufficiently account for the fact that the probability of supplier failure has significantly reduced since 2021, when the sector experienced an unprecedented level of price volatility.
- 19 As a result of the mass supplier exits in 2021-22, and Ofgem's actions since the 'retail crisis' (including the introduction of quarterly stress testing, enhanced financial responsibility principles and tighter controls on licence applications), the number of suppliers without sound risk management is materially lower today than it was during the reference period used by Ofgem in its work. Further, the remaining market participants have proven their financial resilience by, as set out in Hesmondhalgh 1 §37, having weathered a period of exceptional stress.
- 20 In the Impact Assessment, Ofgem assumes that the pre-policy default risk of all 'challenger' and 'small' suppliers is the same (with an annual default rate of 7.95%). The contention that the average annual default risk of challenger suppliers is 8% year-on-year is grossly overestimated. If it were true, this would mean that over the course of the next 6 years nearly 50% of all challenger suppliers would fail, which is clearly unreasonable.
- 21 As set out in detail in Casey 1, GEMA failed to take into account the smaller number of more resilient suppliers, operating in a now more stringent regulatory environment. As a result, the Impact Assessment and the Decision overestimate the probability of future supplier failure. This supports the Appellant's contention in §55 of the NOA that an energy market with a Capital Target would not face materially lower levels of supplier failure than one without (and so, the Capital Target would not achieve its objectives), i.e., the material reduction in supplier failure has already crystallised, by way of the weeding out of higher risk suppliers, and the regulatory decisions already made by Ofgem since the crisis.

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22 Second, Ofgem has overstated the benefit to consumers in respect of costs saved from supplier failure events. Increased costs in the event of supplier failure primarily results from the mutualisation of renewable obligation (**RO**) costs, customer credit balances (**CCBs**), and replacement hedges following measures undertaken as a result of the Special Administration Regime (**SAR**) or Supplier of Last Resort (**SoLR**). In the Impact Assessment, Ofgem has overstated the costs relating to the mutualisation of each of these three categories of costs. In particular, Ofgem has overestimated costs relating to:

- (a) **mutualisation of RO payments**: through use of the WACC as a multiplier rather than the default rate to determine the cost to consumers of unprotected RO liabilities;
- (b) **mutualisation of CCBs**: through its selective use of peak seasonal CCBs in its analysis; and its use of an inappropriate scaling factor to estimate future CCBs from historical CCBs; and
- (c) **replacing hedges of failed suppliers**: through use of an inappropriate scaling factor; inappropriate use of 'customers of failed suppliers' data; and through recency bias by erroneously assuming that supplier failure coterminous with the commodity price volatility of the scale seen in 2021 is likely to occur every 6 years.

23 Each of these points is further detailed in Case 1. Case 1 also explains that in its Impact Assessment, Ofgem has overestimated switching costs in the event of supplier failure.

24 As a result of overstating the costs that the Capital Target is intended to prevent from being mutualised, Ofgem inevitably overestimates the benefits of the Capital Target.

25 In addition, the Impact Assessment fails to appropriately account for the measures Ofgem has put in place since the retail crisis in 2021/22 to limit the risk of these costs being mutualised in the event of supplier failure. This is over and above the effect of measures that limit the risk of failure in the first place. These include the requirement to ringfence RO liabilities, and to maintain cash collateralisation sufficient to meet 20% of net CCBs. Even if the actual objective of the Capital Target is to provide a loss-absorbing buffer for suppliers and an early warning for GEMA to allow it to intervene in a timely manner – as Ofgem has suggested – this is already addressed by measures already put in place by the regulator. This supports the argument raised by the Appellant in §56 of the NOA.

Underestimation of costs

26 Not only does Ofgem's Impact Assessment overestimate the benefits of introducing the Capital Target, it also understates the costs of introducing this measure, further skewing its overall conclusions.

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27 First, the Capital Target will have a negative impact on retailers' financial resilience, contrary to its stated objective. As highlighted in Casey 1, errors in the Impact Assessment lead Ofgem to overstate the ability of independent suppliers to raise equity and/or debt in the current regulatory and market environment. In particular, Ofgem is wrong to conclude that the Capital Target will result in improved credit ratings and the regulator also underestimates the cost of capital of introducing the Capital Target.

28 In fact, by introducing the Capital Target, GEMA will increase the risk that otherwise sustainable suppliers exit the market as a result of their inability to meet the Capital Target, as set out further in paragraph 33 below. This supports the Appellant's point in §60 of the NOA that the Capital Target puts fundamentally resilient challenger suppliers in an unsustainable position, for minimal (if any) benefit.

29 Second, Ofgem has failed to properly evaluate the trade-off between competition and financial resilience in setting the Capital Target, and its Impact Assessment fails to adequately assess the negative impact this measure will have on competition and innovation, to the detriment of consumers. This supports, in particular, the Appellant's arguments in §§58-59 of the NOA and is further discussed in Casey 1 and Starks 1.

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

30 Not only will the Capital Target not result in the consumer benefits stated by Ofgem, but it is also likely to have a negative impact on financially responsible suppliers, to the detriment of consumers. Given the lack of customer benefit resulting from the Capital Target, and the severe consequences it (and the associated compliance framework) will have on individual suppliers and the sector as a whole, OVO agrees that the measure is disproportionate as argued by the Appellant in §76 of the NOA.

31 As set out in relation to Ground 1, it is clear that the Capital Target will result in no net consumer benefit at all, in fact, it will result in consumer detriment. [REDACTED]

[REDACTED]

32 [REDACTED]

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- 33 Instead of ensuring that suppliers in the Intermediate Position do not fall below the Capital Floor, the measures imposed will significantly impede relevant suppliers' ability to meet the Capital Target. The consequence of falling below the Capital Target is likely to be a significantly weakened financial position, due to increased levels of regulatory uncertainty and resulting trigger events, which could lead to the exit of suppliers with otherwise resilient business models and effective risk management practices.

REMEDIES

- 34 Based on these substantive arguments, OVO supports the request by the Appellant that the CMA quash the Decision insofar as it imposes the Capital Target in supplier licences.

CONTACT DETAILS

- 35 Intervener:

OVO Energy Limited (on behalf of OVO Electricity Limited and OVO Gas Limited)

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STATEMENT OF TRUTH

37 OVO Energy Limited believes that the facts stated in this application for permission to intervene are true.

Signed:

A black rectangular redaction box covering the signature of Vincent Francis Casey.

Dated: 12 October 2023

Vincent Francis Casey, Chief Financial Officer

For and on behalf of OVO Energy Limited