

Financial Resilience Appeal 2023

Summary of Final determination

Issued: 19 January 2024

1. The Office of Gas and Electricity Markets (Ofgem) regulates the companies that supply energy to consumers and businesses in Great Britain. Ofgem is governed by the Gas and Electricity Markets Authority (GEMA).

What is the GEMA decision under appeal to the CMA?

2. On 26 July 2023, GEMA published its ‘Decision on introducing a minimum capital requirement and ringfencing customer credit balances by direction’, modifying the Standard Licence Conditions (SLCs) for all gas and electricity suppliers in Great Britain (the Decision). The modifications included the introduction of a common minimum capital requirement. The common minimum capital requirement sets a Capital Floor of £0 Adjusted Net Assets per dual fuel equivalent customer and a Capital Target of £115 Adjusted Net Assets per domestic dual fuel equivalent customer.
3. As modified, the SLCs will require suppliers, from 31 March 2025, to maintain the Capital Floor at all times. A supplier that is above the Capital Floor but below the Capital Target (defined as being in the Intermediate Position) will be subject to certain restrictions¹ until it has had a plan approved by GEMA to achieve the Capital Target (a Capitalisation Plan).

Who appealed GEMA’s Decision?

4. In August 2023, Utilita Energy Limited (**Utilita**) applied to the CMA for permission to bring an appeal against GEMA’s Decision. Having considered Utilita’s application and representations received from GEMA in September 2023, the CMA granted Utilita permission to bring its appeal. Utilita advanced three grounds of appeal:
 - Ground 1: that GEMA erred in concluding that the Capital Target would further the objectives it was intended to achieve;
 - Ground 2: that GEMA erred in calculating the level at which the Capital Target ought to be set; and

¹ The specific restrictions include a ban on sales (ie a ban on customer acquisition) and non-essential payments (including dividends) (the ‘Transition Controls’)

- Ground 3: that the Capital Target (at any level, and certainly at the designated level) is unnecessary and disproportionate.
5. In October 2023, EDF Energy Customers Limited (EDFE) and OVO Energy Limited (OVO) each sought permission to intervene in the appeal. EDFE sought permission to intervene in support of GEMA. OVO sought permission to intervene in support of Utilita. The CMA allowed these interventions for Grounds 1 and 3 only.
 6. The main submissions of Utilita, GEMA, OVO and EDFE can be found on the CMA case page [here](#).

What has the CMA decided?

7. We have decided that GEMA's Decision was not wrong on the basis of any of Utilita's grounds of appeal. We have therefore confirmed GEMA's Decision. We summarise below why we reached this conclusion.²

Ground 1 - GEMA erred in concluding that the Capital Target would further the objectives it was intended to achieve

8. The central premise of Utilita's Ground 1 was that the introduction of the Capital Target fails to achieve GEMA's stated effect of helping 'deliver a retail energy market that is secure, sustainable, and therefore able to deliver the innovation and positive consumer outcomes needed in the future'.³ We summarise our decision on Ground 1 as follows.

Levels of supplier failure and mutualisation costs⁴

9. The stated effects of the Decision included reducing the probability of supplier failure and reducing the expected level of mutualisation costs should failure occur. Utilita argued that the Decision was wrong because the introduction of the Capital Target would not achieve these stated effects.
10. In support of this ground of appeal, Utilita made submissions related to the theoretical basis for GEMA's view; evidence from the recent energy crisis; and the scope for relevant risks to be addressed adequately under the existing regulatory framework.
11. We were not persuaded by Utilita's arguments. Our assessment included that:

² This high level summary is not part of the final determination. It aims to provide a separate overview for a wider audience.

³ Utilita also alleged that GEMA had made various errors of fact, failed properly to have regard to or to give appropriate weight to various mandatory considerations, and had been wrong in law.

⁴ This refers to residual costs that may arise in the event of supplier failure, which are borne by consumers (or in some cases ultimately by taxpayers).

- (a) Utilita had not shown that GEMA's theoretical basis for concluding that having a positive loss-absorbing capital buffer would reduce the risk of supplier failure and the likely mutualisation costs was flawed.
- (b) Utilita's submissions regarding the implications of experience from the energy crisis did not adequately engage with the question of what effects the existence of a Capital Target ahead of the energy crisis might have had on levels and costs of supplier failure. We therefore concluded that Utilita had not shown that GEMA's assessment of the evidence from the energy crisis was flawed.
- (c) It was not in dispute that other measures introduced by GEMA (either previously or alongside the Capital Target) would contribute to addressing the risks that the Capital Target is also aimed at addressing. However, we concluded that Utilita had not shown that GEMA was wrong to have concluded that the Capital Target would be likely to further address these risks.

Impacts on competition and innovation

12. Utilita argued that GEMA had failed properly to have regard to or to give appropriate weight to various mandatory considerations that were relevant to the assessment of impacts on competition. It argued that the imposition of the Capital Target would systematically favour incumbent suppliers and traditional energy supply models, driving down competition and innovation.
13. We were not persuaded by Utilita's arguments. Our assessment included that:
 - a. GEMA had considered impacts on competition extensively during the processes through which it developed and introduced the Capital Target.
 - b. The submissions we received had not shown that GEMA was wrong to have concluded that the introduction of the Capital Target would have a beneficial impact on competition by removing incentives which had otherwise tended to lead to excessive risk taking and unsustainable commercial behaviour.
 - c. GEMA had explicitly acknowledged that allowing suppliers to use parent company guarantees to meet the Capital Target might have an impact on competition, but concluded nevertheless that it would not be in the consumer interest overall to exclude their usage.
 - d. The submissions we received that GEMA had failed to take appropriate account of the impact the Intermediate Position might have on competition were not persuasive.

- e. While the relationship between future price cap decisions and the requirement for suppliers to meet the Capital Target is important (as it could have a material bearing on the scope for suppliers to accumulate capital), GEMA was not wrong to assume that the price cap would be set on a basis that provides for an appropriate return on capital, recognising the need for suppliers to meet the Capital Target.
- f. The submissions we received that GEMA had failed to take appropriate account of potential impacts of the Capital Target on supplier entry were not persuasive.
- g. GEMA's evidence showed it had properly considered both the risks that individual suppliers might exit the market because they were unable to meet the Capital Target, and what the likely impact of such exit might be on competition should it occur.

14. We decided that the evidence we received had not shown GEMA to have erred in forming its overall view that the Capital Target would have a net beneficial effect on delivering 'the innovation needed in the future'. In a context where there was inevitably considerable uncertainty associated with many aspects of its assessment, we found that it was within GEMA's margin of appreciation to have formed that overall view.

GEMA's Impact Assessment and its conclusion that the Capital Target would deliver positive consumer outcomes

15. Utilita argued that GEMA was wrong to conclude that the Capital Target would deliver positive consumer outcomes as the Decision was based on an Impact Assessment which contained errors.
16. We noted that GEMA's Impact Assessment was one of several factors it considered when making its Decision. We therefore considered whether there were errors in GEMA's Impact Assessment and, if there were errors, whether the cumulative effect of these errors would lead us to conclude that, taking into account other factors, the Decision was wrong.
17. We considered there to be significant regulatory judgement involved in assessing the impact of the Capital Target. There is no single correct way to conduct the Impact Assessment. We accordingly afforded GEMA an appropriate margin of appreciation in how it conducts its Impact Assessment. However, we found that there were some errors in GEMA's approach, specifically relating to the calculation of future hedging costs transferred to customers in the event of supplier failure. However, when we corrected for these errors (and considered the uncertainty of the impact of the Capital Target on credit ratings), we found that the result of the Impact Assessment model remained positive for consumers.
18. Overall, we concluded that the Decision was not wrong on the basis of Ground 1.

Ground 2 - GEMA erred in calculating the level at which the Capital Target ought to be set

19. In Ground 2, Utilita argued that GEMA erred in calculating the level at which the Capital Target ought to be set. Utilita also argued that the figure which has been chosen for the Capital Target was the result of methodology which is based on unreliable data and is arbitrary and irrational and is thus an error of law.
20. We concluded that GEMA was not wrong to set the Capital Target at £115. In particular, we considered that GEMA's use of historic profit margins⁵ was a reasonable basis on which to calculate the Capital Target and that GEMA's decision to do so was therefore not wrong. We also concluded that GEMA did not make any errors in its calculations and assumptions underlying that analysis.
21. GEMA's reduction in the Capital Target to £115 (from the £145 calculated using the historic profit margin analysis) was based on a number of qualitative and quantitative factors, including differences between the risks incurred by different suppliers, other regulatory protections GEMA had introduced to improve financial resilience and the potential regret risk of setting the target too high. We concluded that GEMA's reduction in the Capital Target could be justified by the factors it highlighted and was within GEMA's margin of appreciation and therefore not wrong.

Ground 3 - the Capital Target is unnecessary and disproportionate

22. In Ground 3, Utilita argued that GEMA's decision to introduce the Capital Target and the associated compliance framework was contrary to the principles under which regulatory activities should be proportionate and targeted.
23. In particular, Utilita argued that imposing a common Capital Target on all suppliers was disproportionate given the differing risk profiles of some suppliers, like Utilita, and that GEMA was wrong not to include greater flexibility for the case in which a resilient supplier briefly falls below the Capital Target threshold.⁶
24. Based on the evidence we have seen, there is considerable uncertainty as to the relative merits of a common Capital Target and a risk-based Capital Target, each with competing advantages and disadvantages. As a result, we were not persuaded that a risk-based Capital Target would be clearly preferable to a common Capital Target. With regards to a Capital Target with greater flexibility, we considered two ways this might be achieved. Firstly, by permitting suppliers to dip below the Capital Target by a certain amount without being subject to the compliance framework. We found this option not to be clearly preferable as this would effectively reduce the level at which the Capital Target was set. Secondly, by permitting suppliers to be below the Capital Target for a

⁵ Historic profit margins are assessed using EBIT margins (at the 5th percentile)

⁶ In Ground 3, Utilita also repeated a number of the arguments that it had made in support of Ground 1.

period of time before being subject to the compliance framework. Whilst we recognise that there may be some potential advantages for suppliers, there are also potential disadvantages, including that, for the duration of any grace period, suppliers would have less incentive to agree an appropriate Capitalisation Plan with GEMA and could engage in potentially excessive risk taking.

25. Overall, we concluded that GEMA's Decision was not wrong on the basis of this Ground.

Overall CMA Determination

26. We have determined that the Decision is not wrong on the basis of any of the grounds of appeal advanced by Utilita. Accordingly, we do not allow the appeal, and confirm the Decision appealed against.