FINANCIAL RESILIENCE APPEAL 2023

Appendix and Glossary

19 January 2024

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Appendix A: Methodology for changes in assumptions in the Impact Assessment model

A.1 This appendix sets out the methodology we used to apply revised hedging cost assumptions in GEMA's Impact Assessment model. We used the Impact Assessment model published by GEMA in July 2023.[1]

Impact Assessment scenario used

A.2 GEMA's Impact Assessment model includes different policy options which include the Capital Target, the Capital Target only (Option 3) and the Capital Target and ringfencing of RO receipts (Option 4). The ringfencing of RO receipts (Option 2) was introduced before the Capital Target in GEMA's April 2023 decision on strengthening financial resilience.[2] The table below summarises the different options GEMA considered and the net benefits of each option.

Table A.1: Results of GEMA's Impact Assessment model

GEMA's assessment of monetised customer benefits (2023-2028 average, per year)[3]	1. Market-wide RO and CCB ringfencing	2. Market-wide RO ringfencing	3. Capital adequacy	4. Capital adequacy + market wide RO ringfencing
Ringfencing cost and mutualisation of CCB/RO	-31	-16	13	-11
Hedging cost	24	19	37	49
Inefficient switching	43	33	17	40
Admin costs	11	9	5	10
Pricing dynamics of large suppliers	-12	-1	-19	-25
Total (£m)	**36**	**44**	**53**	**63**
Total per customer (£)	**1.22**	**1.51**	**1.80**	**2.15**

Source: Revised impact assessment of Strengthening Financial Resilience proposals (ofgem.gov.uk), Table 1. Nb the CMA has amended the final row heading to £ rather than £m.

A.3 We considered that an incremental scenario, which we calculated as the difference between Option 4 and Option 2 in the table above, would properly capture the incremental impact of the Capital Target. However, GEMA stated that it was not appropriate to consider the incremental scenario, as the Impact

[1] Ofgem's published impact assessment model, Public version - FRC IA model July 2023. (**Impact Assessment model)**.
[2] Ofgem, Decision on Strengthening Financial Resilience, 5 April 2023.
[3] The final row showing total per customer is in £ not £m as stated in GEMA's table.

Assessment model assesses the impact of the regulatory changes overall. GEMA also noted that there is a quirk in the model whereby the greatest benefits in terms of risk reduction derive from the measure which is implemented first in time.[4]

Our analysis of the impact of the changes in the hedging cost assumptions under the incremental scenario are consistent with GEMA's submissions. We found that when we made changes to hedging costs in the model, the resulting changes to the incremental impact of the Capital Target did not appear appropriate.

(a) This is because changing the hedging cost assumptions has two impacts. First, a reduction in the benefit due to the reduction in the hedging costs exposure and second, an improvement in credit ratings due to the reduction in the hedging costs exposure. When making our changes the reduction in the benefits is largest under the RO only scenario as the reduction in the hedging cost exposure was only partially offset by a small improvement in credit ratings.

(b) In the CT and RO scenario, there was the largest improvement in credit ratings (and the corresponding default rates/cost of capital) which offset the reduction in the benefit due to the change in hedging cost assumptions.

(c) However, under the incremental scenario (which we calculated as the difference between the CT and RO and RO only options) the benefit increased with the implementation of the revised hedging cost assumptions. This is because the reduction in the benefit was larger in the RO only scenario which is then deducted from the reduction in the benefit in the CT and RO scenario.

A.4 We therefore used the Capital Target only scenario (Option 3) as the primary methodology for our assessment of the impact of changes in assumptions in the model. We recognise that there is uncertainty to this due to the impact of the RO ringfencing introduced in April.

Methodology used to change assumptions in the Impact Assessment model

Customer numbers

A.5 OVO provided alternative assumptions for the customer numbers used to calculate the per customer historical hedging costs, this involves using the maximum number of customers of failed suppliers (approximately 4.0 million customers) rather than a simple average (approximately 2.3 million customers).

[4] GEMA's response to questions arising from the Hearing, 7 November 2023, paragraph 11.

A.6 We applied this in the model by changing cell BX26 on the 'Customer groups' sheet from an AVERAGE to a MAX function. The impact of this change is to reduce the net benefit per customer from £1.80 to £1.61, as stated in Chapter 4.

Forecasting the level of future hedging costs

A.7 OVO proposed changing the price cap scalar[5] to 1, or less than 1, to reflect the high commodity price environment in 2022 when the Bulb hedging costs were incurred. However, we do not think this scalar would be appropriate as some of the hedging costs were incurred prior to 2022 when the commodity prices were lower.

A.8 We tested an alternative sensitivity to understand the implications of different assumptions. To do this we calculated a weighted average price cap scalar which uses the 2020-2021 price base for 31.5% of the costs and a 2022 price base for the 68.5% of costs relating to Bulb. This equates to an annual price cap scalar as set out in Table A.1 below.

Table A.2: price cap scalar for hedging costs[6]

	2023	*2024*	*2025*	*2026*	*2027*	*2028*
GEMA price cap scalar	2.62	3.04	2.52	2.34	2.34	2.34
CMA price cap scalar for hedging costs	1.83	2.12	1.76	1.63	1.63	1.63

Source: CMA analysis of GEMA Impact Assessment model.

A.9 We applied our annual weighted average price cap scalar set out above to rows 171 and 448 in the 'Consolidated Model' sheet in the Impact Assessment model. The impact of this further change to hedging costs is to reduce the net benefit further per customer to £1.53, as discussed in Chapter 4.

Credit rating sensitivity

A.10 Given the uncertainty regarding the improvement in credit ratings assumed by GEMA in its base case, we also considered a sensitivity (applied in combination with the hedging costs changes outlined above), which assumed that credit ratings would only improve by 50% of the level assumed by GEMA.

A.11 GEMA's Impact Assessment model included a 'Credit Rating Analysis' sheet and we used this to run the credit rating sensitivity. In the pre-policy position, GEMA's model assumes that the small and challenger suppliers have the mix of credit ratings set out in Table A.2.

[5] The scalar is used by GEMA to convert historical hedging costs into a future assumption on hedging costs in the event of supplier failure. The scalar is calculated by comparing the historic price cap with GEMA's future expectation of prices.
[6] Calculated as set out in paragraph A.7 and rounded to two decimal places.

Table A.3: small and challenger supplier credit ratings in GEMA's pre-policy position

	2023	2024	2025	2026	2027	2028
% AA	-	-	-	-	-	-
% A	-	-	-	-	-	-
% BBB	-	-	-	-	-	-
% BB	-	-	-	-	-	-
% B	35%	35%	35%	35%	35%	35%
% CCC	65%	65%	65%	65%	65%	65%

Source: CMA analysis of GEMA Impact Assessment model.

A.12 In the post-policy Option 3 (capital adequacy requirements only), with the hedging cost changes detailed above applied, the small and challenger suppliers had the mix of credit ratings set out in Table A.3.

Table A.4: small and challenger supplier credit ratings under Option 3 with the hedging cost changes applied

	2023	2024	2025	2026	2027	2028
% AA	-	-	-	-	-	-
% A	-	-	-	-	-	-
% BBB	-	-	-	-	-	-
% BB	-	-	-	-	-	-
% B	35%	35%	81%	82%	82%	82%
% CCC	65%	65%	19%	18%	18%	18%

Source: CMA analysis of GEMA Impact Assessment model.

A.13 These two tables show that from 2025, approximately 46% of small and challenger suppliers are assumed to have an improved credit rating (from CCC to B) following the introduction of the Capital Target.

A.14 We therefore considered a sensitivity where the improvement in credit ratings was at a rate of 50% of that assumed in GEMA's model, ie 23% of small and challenger suppliers having an improved credit rating from CCC to B. Table A.4 sets out the mix of credit ratings for small and challenger suppliers under this sensitivity.

Table A.5: small and challenger supplier credit ratings under Option 3 with the hedging cost changes assuming only a 50% improvement in credit ratings

	2023	2024	2025	2026	2027	2028
% AA	-	-	-	-	-	-
% A	-	-	-	-	-	-
% BBB	-	-	-	-	-	-
% BB	-	-	-	-	-	-
% B	35%	35%	58%	58%	58%	58%
% CCC	65%	65%	42%	42%	42%	42%

Source: CMA analysis of GEMA Impact Assessment model.

A.15 To assess the impact of this sensitivity on the outputs of the Impact Assessment model, we included the credit ratings set out in Table A.4, in cells C9 to H14 of the 'Credit Rating Analysis' sheet of the Impact Assessment model.

A.16 Under this sensitivity, the net benefit position per customer decreases from £1.53 calculated earlier to 70p per customer, but remains positive.

Glossary

Term	Definition
Adjusted Net Assets	(Tangible fixed assets + current assets) – (current liabilities + non-current liabilities) + Alternative Sources of Capital approved by GEMA.
Alternative Sources of Capital	Other sources of capital included in the calculation of Adjusted Net Assets including unsecured loans approved by GEMA, fully committed, unsecured, documented loan facility from a parent/group company or unconditional, unsecured, quantifiable, legally-binding, guarantee from a parent or group company.
Brattle Report	Expert Report prepared by the Brattle Group dated 23 August 2023 on behalf of Utilita, which accompanied the NoA by Utilita.
Capital Floor	Regulatory requirement to maintain Adjusted Net Assets at a minimum of £0 per domestic dual fuel customer.
Capital Target	Regulatory target to maintain Adjusted Net Assets at a minimum of £115 per domestic dual fuel customer.
Capitalisation Plan	Regulatory requirement mandating suppliers to show how they intend to meet the Capital Target, should they fall below that level of Adjusted Net Assets.
Cash Coverage Trigger	Requirement to maintain monthly balances of cash in the bank at a level equal to or greater than 20% of gross CCBs net of unbilled consumption owed to their fixed Direct Debit customers.
CAT	Competition Appeal Tribunal
CC	Competition Commission
Challenger Suppliers	New entrants since 2008, including OVO Energy and Octopus Energy.
Customer Credit Balances (CCBs)	Customer credit balances whereby suppliers hold an amount of credit as a result of overpayment by customers.
CMA	Competition and Markets Authority
CMA Energy Market Investigation	Investigation conducted in 2016 by the CMA into the supply and acquisition of energy (See: Energy market investigation - GOV.UK (www.gov.uk)).

Term	Definition
CMA70	Energy Licence Modification Appeals: Competition and Markets Authority Rules (The Rules) (See: Energy licence modification appeals: rules.
CMA71	Energy Licence Modification Appeals: Competition and Markets Authority Guide (The Guidance) (See: Energy licence modification appeals: guide.
Compliance framework	In essence, the consequences that flow from a supplier falling below the Capital Target. In particular, the default Transition Controls (including restrictions on sales and non-essential payments, including distributions) pending the approval of a Capitalisation Plan by GEMA, along with GEMA's ability to require restrictions on sales and non-essential payments in any Capitalisation plan.
Deadband	Tolerance level below the Capital Target and above the Capital Floor, which if Adjusted Net Assets remains above the deadband the Transition Controls would not apply.
Decision	GEMA's decision published on 26 July 2023 to introduce a common minimum capital requirement in relation to the modifications of standard licence conditions and to impose a capital target in respect of gas and electricity supply licences.
EA89	The Electricity Act 1989
EBIT margin	A portion of the Earnings before Interest and Tax (EBIT), calculated as the level of capital employed multiplied by the cost of capital, to allow suppliers to earn a fair return on their investments.
ED1 Determinations	British Gas Trading Limited v GEMA, Final Determination, 29 September 2015; and Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v GEMA, Final Determination, 29 September 2015.
ED2 Determination	Energy Licence Modification Appeal 2023 – Final Determination dated 21 September 2023.
EDFE	EDF Energy Customers Limited, wholly owned by the French state-owned EDF (Électricité de France).

Term	Definition
eFRP	Enhanced Financial Responsibility Principle, introduced by GEMA on 5 April 2023. For the FRP, see below.
ELMA 2021	Energy Licence Modification Appeal 2021 – Final Determination dated 28 October 2021.
Final Determination (FD)	The CMA's Final Determination in this appeal issued on 19 January 2024 to Utilita, GEMA, EDFE and OVO.
Firmus Energy	Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation, Final Determination, 26 June 2017.
Flint Report	Expert Report prepared by Flint Global dated 12 October 2023 on behalf of OVO, which accompanied the NoI by OVO.
FRP	Financial Responsibility Principle, introduced by GEMA for suppliers in 2020. The FRP was introduced as part of the Supplier Licensing Review (SLR) reforms. The FRP acts as an over-arching obligation – supporting one of the key aims of the SLR by ensuring suppliers act in a more financially responsible manner and take steps to bear an appropriate share of their risk.
FTC	Fixed Tariff Contract
GA86	The Gas Act 1986
GEMA	The Gas and Electricity Markets Authority which is the sector regulator and Board (consisting of non-executive and executive members and a non-executive chair) that governs Ofgem. The PD refers to GEMA throughout the document.
GEMA Response	Response by GEMA to the NoA, dated 12 October 2023.
GEMA Closing submissions	Closing submissions by GEMA following the Hearing dated 7 November 2023.
Hearing	The Hearing held by the CMA Appeal Group, over 30 and 31 October 2023. Utilita, GEMA, EDFE and OVO all attended the Hearing.
Hearing transcript	Transcript of the Hearing held on 30 and 31 October 2023.

Term	Definition
Hedging	An arrangement where suppliers buy bulk energy in advance using forward contracts to match the expected demand and in order to absorb the shock of any rapid and sustained increase in wholesale energy prices.
Impact Assessment (IA)	Analysis performed by GEMA to measure the net benefits/costs of introducing the Capital Target and Capital Floor.
Incumbent Suppliers	Formerly known as 'the big six' but currently comprise of only four companies: British Gas, EDFE, E.ON, and Scottish Power. SSE and npower exited the market in 2020 and 2021, respectively.
Intermediate Position	When a supplier holds Adjusted Net Assets between the Capital Floor and Capital Target.
Interveners	EDFE and OVO
Licence(s)	An electricity supply licence under section 6(1)(c) EA89 or a gas supply licence under s7A GA86 .
LNG	Liquified Natural Gas
Mutualised costs	The costs passed to domestic customers following supplier failure.
NoA	The Notice of Appeal by Utilita dated 23 August 2023
NoI	Notice of Intervention submitted by EDFE and by OVO Energy on 12 October 2023.
Ofgem	The Office of the Gas and Electricity Markets which is Governed by GEMA. The FD refers to GEMA throughout the document.
OGL	OVO Group Limited
Other Entrants	Smaller new entrants, including Utilita and others such as SO energy, Rebel, E, Foxglove.
OVO	OVO Energy Limited, part of the **OGL** and OVO Finance Ltd.
Oxera Report	Report commissioned by GEMA and published on 6 May 2022.
Parties	Collectively Utilita, GEMA, EDFE and OVO.

Term	Definition
PCG	Parent Company Guarantee is a contractual guarantee by a Parent Company, in this case, in the form of capital to bolster the suppliers' ability to meet the Capital Target.
Prepayment Price Cap	The price cap was first introduced in 2017 for prepayment customers (both smart and traditional prepayment meters) only, as these customers were unlikely to switch or able to switch to benefit from competitive fixed tariffs. It is still retained today due to price volatility in the market.
Price Cap Scalar	A scaling factor applied in GEMA's Impact Assessment model to account for the assumed increase in the price cap over the evaluation period.
Provisional Determination (PD)	The CMA's provisional determination issued on 4 December 2023 to Utilita, GEMA, EDFE and OVO.
Price caps	Collective term for the prepayment and direct debit and credit SVT price caps.
Renewable Obligations (RO)	Annual obligation on electricity suppliers to present to GEMA a specified number of Renewables Obligation Certificates (ROCs) per megawatt hour (MWh) of electricity supplied to their customers during each obligation period.
REGOs	Renewable energy guarantees of origin
SAR	Special Administration Regime
SLC	Standard Licence Conditions, that apply to all licenced suppliers supplying domestic and non-domestic customers.
SoLR	Supplier of Last Resort is a supplier who takes over the responsibility for continuing the supply of energy to the customers of another gas or electricity supplier who has become insolvent and whose supply licence has been revoked by GEMA.
SONI	SONI Limited v Northern Ireland Authority for Utility Regulation
SVT	Standard variable tariff
SVT Price Cap	A price cap for customers on SVTs who paid by direct debit or credit was first introduced in 2019 to protect consumers and remains in force today.

Term	Definition
Teach In	Teach-in session held with GEMA and Utilita informing the CMA of background information relevant to this appeal, held on 6 October 2023.
Transition Controls	Financial restrictions placed on suppliers until the Capitalisation Plan is agreed.
Utilita	Utilita Energy Limited, a wholly owned subsidiary of Utilita Group Limited.
Utilita Reply	Reply by Utilita on 25 October 2023 to GEMA Response.
Utilita Closing Submissions	Closing submissions by Utilita following the Main Party Hearing dated 7 November 2023.
WACC	Weighted Average Cost of Capital