Dear Sir/Madam,

I am responding on Questions 6, 7 and 9.

6. Do you agree with our proposal to introduce new milestone assessments for suppliers? Do you think the milestones we have proposed and the factors we intend to assess are the right ones? Are there additional factors we should consider to help us to identify where suppliers' may be in financial difficulty?

There should be a milestone for risk management of wholesale price risks.

7. Do you agree with our proposal to introduce an ongoing fit and proper requirement? Are there additional factors, other than the ones we have outlined, that you believe suppliers should assess in conducting checks?

The supplier should have sufficient expertise to quantify and actively risk manage their wholesale price risk. If they cannot resource this in-house, outside expertise should be brought in to ensure there is appropriate ongoing oversight and evaluation of these risks.

9. Do you agree with our proposed scope for independent audits? Please provide rationale to support your view.

The independent audits should also assess management's quantification of, and hedging strategy for, wholesale price risk.

Supporting evidence:

<u>Impact Assessment:</u>

1.4. There are a number of reasons why a supplier can fail, depending on each individual case. For example, this can include the **suppliers risk management strategy**, the withdrawal of key partnerships, failure to adequately prepare for Renewables Obligation (RO) payments or poor behaviour leading to compliance or enforcement action being undertaken by the regulator. This, **combined with external market factors, such as suppliers' exposure to wholesale market price shocks in 2016 and 2018, has resulted in sixteen suppliers failing since November 2016**.

1.8. Adverse selection A responsible supplier will be able to offer both cheap prices and effective risk management (therefore avoiding failure), but consumers are only able to compare tariffs. **This gives an advantage to the riskier suppliers**, as they are able to offer cheaper tariffs (by offering tariffs that are unsustainably low or not designed to make a profit) and therefore **take customers away from suppliers with better risk management**.

1.13. In addition, suppliers who need to increase their working capital may also take an **excessively risky or reckless approach to hedging** in order to save money. We saw that **eight of the supplier failures occurred during a cold autumn and winter period when wholesale prices were high (October 2018 to March 2019), which may suggest that these suppliers took excessive risk by hedging insufficiently**. This is because under-hedging can lead to large profits if the wholesale price upon delivery is lower than the agreed tariff price.

Suppliers are able to do this because they can utilise customer credit balances to finance operations if their risk-taking does not pay-off.

2.13. Ultimately **the consequences of poor risk management are felt by consumers** and can take the form of poor quality of service or increased prices as a result of supplier failure.

2.14. This section demonstrates that **some suppliers do not deploy effective risk management strategies**, and in some cases are not adequately prepared or resourced for growth. We look at how **excessively risky business strategies – for example in relation to hedging** or growth – can contribute to a suppliers failure, and compare quality of service metrics of failed suppliers who grew quickly against the average.

An excessively risky approach to hedging could contribute to supplier failure

2.15. Our analysis shows that if there were no further policy changes under the SLR, we would continue to see suppliers taking an excessively risky approach to running their business, which can contribute to failure. Due to the difficulty in estimating the extent and costs of poor risk management by suppliers, we use their approach to hedging as a proxy.

2.16. We have observed some correlation between wholesale price spikes and suppliers in a weak financial position failing. We reason that this could be due to weak hedging as a result of cash flow issues, financial unpreparedness or miscalculated consumptions needs due to rapid customer growth. There is no one 'right' type of hedging strategy, or that a particular hedging strategy necessarily leads to supplier failure. Rather, **we have observed that** – possibly due to the market failures discussed in the previous chapters – **some suppliers take an excessively risky approach to hedging**.

2.17. We have developed this analysis by looking wholesale electricity prices each month between June 2010 and May 201922 (along with their trend lines) and the timing of various suppliers exiting the market via a SoLR.

2.18. In figure 2.1, we can see a relationship between spikes in wholesale prices (relative to trend) and suppliers failing (and exiting the market via a SoLR) since 2016 (see appendix 2 for the corresponding data table for figure 2.1). Although this might not be the sole reason contributing to supplier failure, it suggests that some suppliers may be incentivised to take an excessively risky hedging strategy, such that their costs increase significantly when wholesale prices increase greatly relative to trend. We also note that suppliers do not always fail there are spikes in wholesale prices relative to trend, as there are numerous reasons why a supplier can fail.

<u>Consultation Document</u>

This does not mention hedging at all, even though the whole of section 2 is "Promoting Better Risk Management" - despite the impact assessment above. Hence our suggested answers to questions 6, 7 and 9.

Executive summary

This consultation sets out a package of proposals to strengthen ongoing requirements on suppliers and arrangements for market exit. These proposals seek to ensure suppliers have effective **risk management** processes in place, maintain appropriate governance and increase accountability, and that our market oversight is increased.

Ongoing requirements

We have set out a package of proposals under the following three themes.

Promoting more responsible **risk management**: This package of reforms looks to address the poor **risk management** practices we have seen from some suppliers. Ultimately the consequences of poor **risk management** are felt by consumers, for instance through poor quality of service.

1.9. At an earlier stage of the Supplier Licensing Review we outlined the four overarching principles we would use to inform our policy development. These are that:

• Suppliers should adopt effective **risk management**, be adequately prepared and resourced for growth, and bear an appropriate share of their risk.

2.24. Expectations of suppliers: Many, if not most, suppliers are already operating in line with the spirit of our envisaged operational principle. As such, this new requirement would be targeted at poor performing suppliers. We expect that its introduction would encourage suppliers to take steps to ensure that their internal processes and systems enable them to serve their customers and comply with their obligations. **This would include taking active steps to identify and mitigate risks.** To support our ability to assess the steps taken by suppliers in this regard, we consider it may be beneficial to specify that suppliers must be able to demonstrate compliance with this obligation to Ofgem.

4.18. Scope of audits: We already gather and analyse a significant amount of information from suppliers relating to a wide range of regulatory obligations. If we introduce an independent audit requirement, we would not want to duplicate the monitoring we already conduct. With this in mind, it may be sensible to focus the scope of an audit requirement on areas where detailed, forensic analysis is required to uncover problems and their causes. **This could mean that audits should be focused around supplier financial accounts, and customer service systems and processes.** *note this does not make any reference to hedging or wholesale price risk assessment.*

I hope our suggestions are of some help. Please email or call if we can clarify or assist further.

Best regards

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Karl Pestell
Director, RGJ Consulting