Department for
Business, Energy
& Industrial Strategy

Modification proposal:	**Smart Energy Code (SEC) Sections A1.1 and J3.2 – J3.13: SECMP0016 Consideration of "Maximum Credit" value in credit cover calculation**		
Decision:	The Secretary of State[1] directs that this modification be made[2].		
Target audience:	Parties to the SEC, the SEC Panel, Ofgem and other interested parties.		
Date of publication:	26 January 2017	Implementation date:	1 April 2017

Background

1. Section J3 of the SEC sets out the arrangements for the calculation of a Party's Credit Cover Requirement in relation to DCC charges. The level of credit cover required is based on a Party's Value at Risk[3] and its Credit Cover Factor as specified in the SEC. The calculation results in an amount of Credit Support that the Party is required to provide to the Data and Communications Company (DCC) in the form of a Bank Guarantee, a Letter of Credit, and/or a Cash Deposit. The Credit Support can be used in the event of a default by a Party to reduce the liabilities of other Parties for Unrecovered Bad Debt Payments. The proposed modification would reduce the amount of credit that is held by the DCC, meaning that Parties would have additional capital to use as they choose.

The modification proposal

2. The Proposer noted that Credit Support is working capital that could otherwise be invested elsewhere in a Party's business. They considered that "high" amounts of Credit Support could create barriers to new market entrants and prevent growth. It was noted that the level of credit cover is currently calculated by reference to a Party's Recognised Credit Rating and this results in the DCC holding Credit Support of approximately 70% of the total Value at Risk for SEC Parties; for some Parties it is over 90%.

3. The modification proposed that a Party's Credit Cover Requirement be calculated with respect to its *Maximum Credit Value*[4] (provided in a Credit Assessment performed by an independent credit assessor) and an *Unsecured Credit Factor* (a percentage of a Party's *Maximum Credit Value*) to be set out in the SEC. Consideration was given to best practice guidance issued by Ofgem[5] and alignment with other industry codes in setting this *Unsecured Credit Factor.* The introduction of these new elements into the calculation result in the aggregate level of Credit Support held by the DCC being approximately 30% of the total Value at Risk, with the range provided by individual Parties varying from around 30% to over 60%.

DCC impact assessment

4. The DCC's impact assessment of the modification indicated that there would be no operational costs to implement it and stated that a lead-time of two months would be needed. The impact assessment also noted:

[1] References to the "Secretary of State", "BEIS", "we" and "our" are used interchangeably in this document. This decision is made on behalf of the Secretary of State.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989 and section 38A of the Gas Act 1986.
[3] Where SEC defined terms are used they have been capitalised.
[4] New SEC defined terms proposed in the modification have been capitalised and italicised.
[5] https://www.ofgem.gov.uk/ofgem-publications/61607/9791-5805.pdf

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- A small increase in short term cash flow risk, which was manageable through existing systems and processes; but no long-term risk to the financial stability of the DCC;
- Minor changes to business processes to change Credit Cover review processes and methodology; and
- No impact on DCC systems.

5. The DCC also modelled the impacts of the modification to identify changes to credit cover required, bad debt risk and the impacts on Parties of different sizes in terms of share of DCC charges[6].

Change Board recommendation

6. At the Change Board[7] meeting on 21 December 2016, a majority of the Change Board approved Modification Proposal SECMP0016, considering that it would better facilitate SEC Objectives (a)[8], (d)[9] and (g)[10].

BEIS decision

7. We have considered the Modification Proposal SECMP0016 dated 3 June 2016 and the Final Modification Report dated 21 December 2016[11] including responses to industry consultations, considerations of the Change Board and such other matters as we consider appropriate. We note that the modification has been progressed in accordance with procedure set out in Section D of the SEC. We have concluded that:

- implementation of Modification Proposal SECMP0016 will better facilitate the achievement of the applicable objectives of the SEC[12] in a way that is compatible with the Transitional Objective[13]; and
- the modification is consistent with our principal objective and other statutory duties[14].

8. We have therefore decided to direct that Modification Proposal SECMP0016, as set out in the Final Modification Report dated 21 December, should be made and take effect from 1 April 2017.

Reasons for our decision

9. We have considered the modification against the SEC objectives (in particular those considered applicable by the Change Board) and our principal objective and statutory duties.

SEC Objective (d): To facilitate effective competition between persons engaged in, or in Commercial Activities connected with, the Supply of Energy under the Principal Energy Legislation

10. There was broad agreement among respondents to the consultations and at the Change Board that the modification better facilitated SEC Objective (d). The main

[6] Smart Energy Code website: https://www.smartenergycodecompany.co.uk/modifications/modification/SECMP-16
[7] The Change Board is a sub-committee of the SEC Panel, established and constituted pursuant to and in accordance with Section D8 of the Smart Energy Code.
[8] SEC Objective (a), facilitating the efficient provision, installation, and operation, as well as interoperability, of Smart Metering Systems at Energy Consumers' premises within Great Britain.
[9] SEC Objective (d), facilitating the effective competition between persons engaged in, or in Commercial Activities connected with, the Supply of Energy.
[10] SEC Objective (g), to facilitate the efficient and transparent administration and implementation of the Smart Energy Code.
[11] Smart Energy Code website: https://www.smartenergycodecompany.co.uk/modifications/modification/SECMP-16
[12] As set out in Condition 22 Part D of the Smart Meter Communication Licence available at: https://www.smartdcc.co.uk/about-dcc/smart-dcc-licence/
[13] As set out in SEC section X1.2 and Condition 22 Part D of the Smart Meter Communication Licence.
[14] The Secretary of State's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 and the Gas Act 1986.

arguments made by Parties were that the modification: reduces financial pressures and increases ability to invest for growth; reduces barriers to entry; aligns with Ofgem best practice; and the increased risk is not disproportionately allocated and remains "roughly" in the same proportions across Parties as current arrangements. One Large Supplier Party disagreed that the modification facilitated objective (d) and considered the effect to be neutral arguing that the credit cover threshold mitigated any barriers to entry.

11. Implementation of the modification would result in Parties being required to provide reduced levels of Credit Support. The modification does not remove the need to provide credit cover and the proposed new calculation uses recognised ratings from independent credit assessors in combination with SEC specific factors aligned to other energy codes. As a result of the modification, Parties will have available capital that they would not otherwise have had, which could be used elsewhere in their business. The data provided by DCC[15] shows that the modification reduces the proportion of Value at Risk held by DCC as Credit Support to 30%, but the effect is dependent on size[16].

12. Reducing the amount of Credit Support held by the DCC increases the level of unsecured debt that Parties are exposed to and could result in Parties being required to make higher Unrecovered Bad Debt Payments if a Party defaults. The modification shifts some risk from an individual Party and its customers to all the SEC Parties required to pay DCC charges and therefore consumers more generally in the event of a default occurring. However, the DCC data shows that the increased exposure to bad debt (in the event of a default) is significantly lower than the corresponding 'saving' in credit cover. The 'saving' could be outweighed by multiple events of default, but the numbers would need to be significant and such a scenario appears unlikely. The additional exposures are in any case generally small.

13. We also note that the modification would align the SEC with Ofgem best practice in regard to 'credit cover'. Whilst the nature of DCC's activities is different to those in other Codes, account should be taken of relevant published best practice. We also note that the Modification Proposal does not remove the requirements to provide credit cover based on risk (i.e. independent credit reports) and Parties would still generally need to provide credit cover. For smaller Parties this remains a significant proportion of their Value at Risk. We accept that the Credit Cover Threshold (the level below which credit cover is not required) goes some way to addressing any concerns about barriers to entry, but we consider that this modification would further reduce barriers to entry and thereby increase competition in energy supply.

14. The modification trades off the amount of capital that Parties have to provide against the potential future need to contribute in the event of a default. We note that there is no material impact on the DCC and that Parties who are well placed to consider the appropriate balance are broadly content. Therefore, having carefully reviewed the material provided, we consider that the modification will better facilitate competition by making additional capital available to Parties for investment in their businesses. We consider this outweighs additional exposure to bad debt in the event of a default occurring.

[15] See footnote 6 for the link and note that DCC's analysis is based on its actual data (suitably aggregated and anonymised) which shows the effect of the modification proposal on Parties. Figures have been shown as averages across 3 tiers: Large Portfolio - Parties liable for 80% of monthly DCC charges; Medium Portfolio - Parties liable for 19.5% of monthly DCC charges; and Small Portfolio - Parties liable for 0.5% of monthly DCC charges (mainly consisting of new market entrants).
[16] The effect is dependent on size, with the average credit cover factor for the large portfolio falling from 48% to 29% (equating on average to £1,619,100-£683,200); for the medium portfolio 63% to 37% (£114,900-£52,600); and the small portfolio 94% to 64% (£4,800-£3,300).

SEC Objective (a) to facilitate the efficient provision, installation, and operation, as well as interoperability, of Smart Metering Systems at Energy Consumers' premises within Great Britain

15. The Change Board considered that the proposal better facilitated objective (a) as it would aid operational efficiencies. There was limited information to support this view and one Large Supplier considered that this modification would be detrimental to this objective because it increased the risk of a defaulting SEC Party having insufficient funds to cover its costs leading to the inefficient socialisation of charges. The points made here appear to be a subset of those in relation to objective (d) addressed above, and on balance we consider that the modification will have a neutral impact on objective (a).

SEC Objective (g) to facilitate the efficient and transparent administration and implementation of the Smart Energy Code

16. The Change Board considered there would be benefit to aligning the SEC arrangements with other Industry Codes to improve the efficiency and transparency of the administration of the SEC. We agree that some efficiencies may be obtained, for example in obtaining credit reports, navigating code requirements etc. However in the absence of further analysis this appears to be a second order point.

Other SEC Objectives

17. We do not consider that this modification will have an impact on any of the other SEC Objectives.

BEIS principal objective and statutory duties

18. We consider that this decision is consistent with our principle objective and statutory duties as it is considered likely to promote competition as outlined above.

Decision notice

19. In accordance with Condition 23.15 of the Smart Meter Communication Licence[17] and section D of the Smart Energy Code as varied by section X2.3, the Secretary of State hereby directs that modification proposal SECMP0016: *Consideration of "Maximum Credit" value in credit cover calculation* be made and take effect from 1 April 2017.

Duncan Stone

Head of Delivery
Smart Metering Implementation Programme
(an official of the Department for Business, Energy & Industrial Strategy authorised to act on behalf of the Secretary of State)

[17] The smart meter communication licences granted under the Electricity Act 1989 and Gas Act 1986.