This document is classified as **White** in accordance with the Panel Information Policy. Information can be shared with the public and any members may publish the information, subject to copyright.

Stage 04: Final Modification Report

SECMP0016:

Consideration of "Maximum Credit" value in credit cover calculation

This Modification Proposal seeks to make changes to the SEC Credit Cover Requirement calculation so that it takes into account the credit value specified by an independent credit assessor.

The Change Board voted to recommend that this modification should be approved on 21st December 2016.

The Authority will make a determination on whether to approve or reject SECMP0016. If approved, this modification will be implemented on 1st April 2017.

Impacts:

- SEC Parties

What stage is this document in the process?

01	Initial Modification Report
02	Refinement Process
03	Report Phase
04	Final Modification Report

Proposer:

First Utility Limited – Jeremy Guard

Jeremy.guard@first-utility.com

Any questions?

Contact:

Sasha Townsend

secas@gemserv.com

020 7090 7755

Administered by Gemserv

8 Fenchurch Place, London EC3M 4AJ

Contents

About this document

This document is the Final Modification Report for SECMP0016. The Change Board considered this report as part of their deliberations on whether to approve, reject, or defer the Modification Proposal. It has been updated following the Change Board vote on 21st December 2016.

The proposed detail changes required to the SEC in order to implement SECMP0016 are included in **Attachment A – SECMP0016 Legal Text**.

Attachment B contains the responses to the Working Group Consultation and the Working Group's consideration of those responses.

Attachment C contains the responses to the Modification Report Consultation.

Attachment D provides the full details of the Change Board vote outcome.

Administered by Gemserv

8 Fenchurch Place, London EC3M 4AJ

1. Summary

This section provides an overview of SECMP0016. For further details on the Modification Proposal, please refer to subsequent sections.

1.1 Why Change?

The current SEC credit arrangements calculate a Party's Credit Cover Requirement by multiplying the Value at Risk (VAR) by a Credit Cover Factor (CCF) determined by the Party's Recognised Credit Rating or Credit Assessment Score. The calculated value is then required to be provided to the Data and Communications Company (DCC) in the form of Credit Support. The DCC currently holds approximately 72% of the total VAR in Credit Support.

The Proposer has highlighted that this Credit Support is working capital that could otherwise be invested elsewhere in a Party's business. They believe that high amounts of Credit Support could create barriers to new market entrants and prevent growth.

1.2 Solution

SECMP0016 was raised by First Utility Limited and recommends that a Party's Maximum Credit Value offered in a Credit Assessment report is considered when calculating a Party's Unsecured Credit Limit. The proposed calculation introduces an Unsecured Credit Factor, in place of the current CCF, that is a proportion of a Party's Maximum Credit Value. The Unsecured Credit Factor is determined by the Party's Recognised Credit Rating or Credit Assessment Score.

This proposed calculation reduces the current Credit Support held by the DCC to approximately 30% of the total Value at Risk for SEC Parties.

1.3 Impacts and Costs

SECMP0016 will impact SEC Parties who are required to provide Credit Support. The total amount of Credit Support that Parties are required to lodge with the DCC will be reduced. However, this will result in higher Unrecovered Bad Debt Payments for Compliant Parties if an Event of Default occurs.

There will be minimal impacts to the DCC's financial arrangements and business processes.

The DCC have confirmed that there will be no additional costs to implement SECMP0016 and so it will be limited to the Code Administrator's time and effort to making the necessary amendments to the SEC.

1.4 Implementation

The recommended implementation date for the Modification Proposal is the 1st April 2017 (the start of the next Regulatory Year).

1.5 Progression Path

This modification is likely to have a material impact on competition. Therefore, SECMP0016 is being progressed as a Path 2 Modification (Authority Determined).

1.6 Modification Report Consulation Responses

12 SEC Voting Groups (representing a total of 14 SEC Parties) responded to the Modification Report Consultation. Of the responses received, one expressed "no interest", one abstained, and one expressed support of rejection. All other respondents supported the approval of SEMP0016.

2. Why Change?

2.1 Background

SEC Section J3 'Credit Cover' sets out that each SEC Party is obliged to provide the DCC with Credit Support in the form of a Bank Guarantee, a Letter of Credit and/or a Cash Deposit. The value of the Credit Support must be equal to or greater than the Party's Credit Cover Requirement.

A Parties Credit Cover Requirement is calculated and reviewed by the DCC on a monthly basis. The diagram below (Figure 1) summarises how a Party's Credit Cover Requirement is currently calculated.

Figure 1: Current Credit Cover Requirement calculation

A Party's Value at Risk (VAR) is the sum of any unpaid DCC invoices and the costs a Party is likely to incur before the next invoice is produced. This sum is then multiplied by the working capital adjustment, which accounts for the working capital cycle for invoices being settled eight Working Days after they have been issued (currently 1.4). This adjustment also takes into account a Parties' possible account growth and ensures that each Party has sufficient Credit Support in place, reducing administration required by the DCC and Parties to arrange additional cover at short term notice throughout the month.

A Party's VAR is then multiplied by the Party's CCF. This is a percentage determined by the Party's (or the provider of the Party's Parent Company Guarantee) Recognised Credit Rating[1] or Credit Assessment Score[2] (provided in a report procured from one of the credit assessment companies, such as Standard and Poor's or Dun and Bradstreet). The value resulting from this calculation will be the Party's Credit Cover Requirement.

Table 1 and 2 below present examples of the current CCFs:

[1] As set out in the table in SEC Section J3.5
[2] As set out in the table in SEC Section J3.8

Table 1: Examples of current CFFs based on Recognised Credit Rating

DBRS		Moody's		Fitch		Standard and Poor's		Credit Cover Factor (%)
Long-Term	Short-Term	Long-Term	Short-Term	Long-Term	Short-Term	Long-Term	Short-Term	
A (low)	R-1 L	A3	P-2	A-	F2	A-	A-2	**0**
BBB (high)	R-2 H	Baa1	P-2	BBB+	F2	BBB+	A-2	**50**

Table 2: Examples of current CFFs based on Credit Assessment Score

Check It (ICC) Credit Score Report	Dunn & Bradstreet / N2 Check Comprehensive Report	Equifax	Experian Bronze, Silver or Gold Report	Graydons Level 1, Level 2, or Level 3 Report	Credit Cover Factor (%)
60-69	3A3/2A2/1A1	C+	60-69	3C/4B/5A	**90**
50-59	2A3/1A2/A1	C/C-	50-59	4C/5B/6A	**100**

2.2 What is the issue?

The Proposer has noted that Credit Support provided in the form of a Bank Guarantee, a Letter of Credit, and/or a Cash Deposit, is working capital that cannot be used by a Party to invest in other areas of their business, for example in systems or people. They believe the level of Credit Support being lodged is too high and should be reduced to support smaller Parties in entering the market and to help their ability to invest in future growth.

It was also noted that new or less established market entrants are unlikely to achieve a Recognised Credit Rating, due to them only trading for a short period of time. Since these Parties are unrated their CCF would have to be determined by their Credit Assessment Score. The Proposer has highlighted that the CCFs determined by a Party's Credit Assessment Score are significantly higher compared to using a Party's Recognised Credit Rating. This results in unrated Parties being required to provide greater amounts of Credit Support. For example, the average CCF for Parties who are liable for 0.5% of monthly DCC Charges (which mainly consists of new market entrants) is currently 94% of their total VAR.

In 2005, Ofgem published a "Best practice guidelines for gas and electricity network operator credit cover"[3] following a review of credit cover arrangements. The conclusion document stated that Ofgem "take the view that an unrated company does not necessary pose a high risk of default" and a "rated entity could well be more likely to fail than a well-run and collateralised smaller company that is unrated". As a result of the review Ofgem set out a number of guidelines, including the introduction of setting unsecured credit limits based on user's Credit Assessment Scores and user's good payment history. These guidelines directed a number of change proposals to the Uniform Network Code (UNC), the Distribution Connection and Use of System Agreement (DCUSA), and the Connection and Use of Systems Code (CUSC).

[3] https://www.ofgem.gov.uk/ofgem-publications/61607/9791-5805.pdf

Whilst noting that the codes targeted by Ofgem's guidelines cover different services to the SEC, specifically the assets of the code's users, the Proposer highlighted that the SEC does not currently offer the same balance for unrated Party's, as recommended by Ofgem.

The Proposer has also noted that the SEC does not currently consider a Party's Maximum Credit Value. The Maximum Credit Value is provided in a Credit Assessment and represents the amount the assessor believes a creditor should have outstanding to the Party at any one time. The WG also noted that the Credit Assessment process takes into account that Parties may have multiple Suppliers. The assessors consider all of a Party's Suppliers when determining the Maximum Credit Value. It's believed that this value should be considered when calculating a Party's Credit Cover Requirement.

3. Solution

3.1 Proposed solution

SECMP0016 proposes to amend the Credit Cover Requirement calculation to determine the unsecured proportion of a Party's SEC credit arrangements based on their Maximum Credit Value.

The current CCF will be changed into an Unsecured Credit Factor (UCF). The UCF will determine a Party's Unsecured Credit Limit as a percentage of the Party's Maximum Credit Value.

A Party's Credit Cover Requirement will then be calculated by subtracting the Party's Unsecured Credit Limit from the Party's VAR. The proposed calculation is represented in the diagram below (Figure 2):

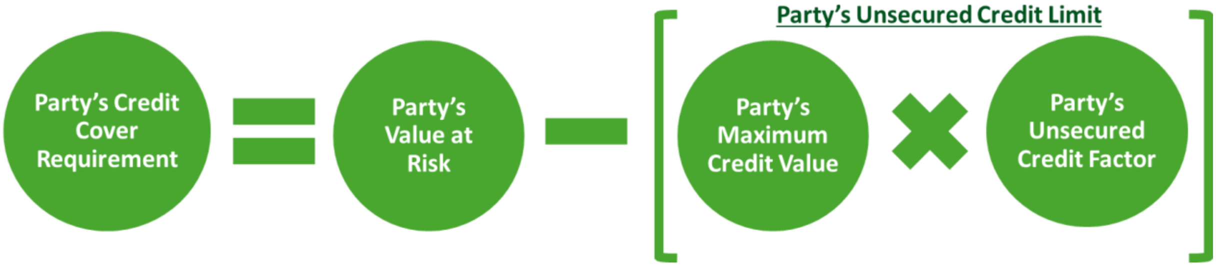


Figure 2: Proposed Credit Cover Requirement calculation.

Party's Value at Risk (VAR)

SECMP0016 does not propose any changes to the current VAR. This will remain as the sum of any unpaid costs invoiced to the Party by the DCC and any costs that are likely to be incurred before the next invoice is produced, multiplied by the Working Capital Adjustment.

Party's Unsecured Credit Limit

A Party's Unsecured Credit Limit is calculated by multiplying the Party's Maximum Credit Value by the Party's Unsecured Credit Factor.

- A Party's **Maximum Credit Value** is provided in a Credit Assessment performed by a Credit Assessor, such as Dun and Bradstreet, and represents the amount the assessor believes a creditor should have outstanding to the Party at any one time.
- A Party's **Unsecured Credit Factor (UCF)** is a percentage of the Party's Maximum Credit Value determined by the Party's Recognised Credit Rating or Credit Assessment Score. The current tables in SEC Section J3.5 and SEC Section J3.8, that determine a Party's CCF, will be replaced with revised tables informing the UCFs.

The proposed new UCFs, based on the Recognised Credit Ratings or Credit Assessment Scores, are displayed in the tables below:

Table 3: Proposed new UCFs based on a Party's Recognised Credit Rating

DBRS		**Moody's**		**Fitch**		**Standard and Poor's**		**Unsecured Credit Factor (%)**
Long-Term	**Short-Term**	**Long-Term**	**Short-Term**	**Long-Term**	**Short-Term**	**Long-Term**	**Short-Term**	
AAA	R-1 H	Aaa	P-1	AAA	F1+	AAA	A-1+	50
AA (high)	R-1 H	Aa1	P-1	AA+	F1+	AA+	A-1+	50
AA	R-1 M	Aa2	P-1	AA	F1+	AA	A-1+	50
AA (low)	R-1 M	Aa2	P-1	AA-	F1+	AA-	A-1+	50
A (high)	R-1 L	A1	P-1	A+	F1	A+	A-1	20
A	R-1 L	A2	P-1	A	F1	A	A-1	20
A (low)	R-1 L	A3	P-2	A-	F2	A-	A-2	20
BBB (high)	R-2 H	Baa1	P-2	BBB+	F2	BBB+	A-2	10
BBB	R-2 M	Baa2	P-3	BBB	F3	BBB	A-3	9.5
BBB (low)	R-2 L	Baa3	P-3	BBB–	F3	BBB–	A-3	9
BBB (high)	-	Ba1	-	BB+	-	BB+	-	8.5
BBB	-	Ba2	-	BB	-	BB	-	8
BBB (low)	-	Ba3	-	BB-	-	BB-	-	7.5

Table 4: Proposed new UCFs based on a Party's Credit Assessment Score

Check It (ICC) Credit Score Report	**Dun & Bradstreet / N2 Check Comprehensive Report**	**Equifax**	**Experian Bronze, Silver or Gold Report**	**Graydons Level 1, Level 2, or Level 3 Report**	**Unsecured Credit Factor (%)**
95-100	5A1/	A+	95-100	1A	10
90-94	5A2/4A1	A /A-	90-94	1B/2A	9.5
80-89	5A3/4A2/3A1	B+	80-89	1C/2B/3A	9
70-79	4A3/3A2/2A1	B/B-	70-79	2C/3B/4A	8.5
60-69	3A3/2A2/1A1	C+	60-69	3C/4B/5A	8
50-59	2A3/1A2/A1	C/C-	50-59	4C/5B/6A	7.5
40-49	1A3/A2/B1	D+	40-49	5C/6B/7A	6.5
30-39	A3/B2/C1	D/D-	30-39	6C/7B/8A	5
20-29	B3/C2/D1	E+	20-29	8B	3.5
10-19	C3/D2/E1	E/E-	10-19	8C	1.5
Below 10	Below E1	Below E-	Below 10	Below 8C	0

The proposed UCF percentages in the new tables are inverts of the current CCFs. These were then adjusted to:

- achieve a percentage of Credit Support of the total VAR, that the WG agreed to be acceptable (30%); and
- decrease at a similar ratio, to those values contained in the UNC, DCUSA, and CUSC.

This reflect a similar matrix to those codes that were amended following the publication of Ofgem's best practice guidelines.

Recognised Credit Rating or Credit Assessment Score

In the case of a Party having both a Recognised Credit Rating and a Credit Assessment Score, the Recognised Credit Rating will always be used to determine the Party's UCF. The proposed solution also requires that each Party, with a VAR that exceeds the Credit Cover Threshold, meets the cost of obtaining a Credit Assessment Score, as often as the Party is reasonably obliged and at least every 12 months.

In the case of a Party having more than one Credit Assessment provided by the specified Credit Assessor agencies, the Party can choose which of the Credit Assessments is used to determine its Unsecured Credit Factor and Maximum Credit Value.

UCF set to Zero

Where a Party does not hold a valid Credit Assessment Score and/or Maximum Credit Value, the Party's UCF and Unsecured Credit Limit will be set to zero. A Party's UCF will also be set to zero where there has been non-payment of an invoice by the due date on more than three occasion within a year, as per the existing provisions.

Credit Cover Threshold

SECMP0016 does not propose amending the current Credit Cover Threshold provisions set out in SEC Section J4.8. This means that Parties who have a calculated Credit Cover Requirement less than £2,000 are not currently required to provide Credit Support to the DCC. This modification proposes that Parties will not need to meet the cost of obtaining a Credit Assessment Score, until their VAR exceeds the Credit Cover Threshold.

3.2 Proposed legal text

The proposed detailed changes required to the SEC in order to implement SECMP0016, are included in **Attachment A – SECMP0016 Legal Text**.

When the SEC was initially designated, only Users were expected to be liable for DCC Charges and this was reflected in SEC Section J3.

On 31st July 2014, SEC Version 4.0 was designated. This version included changes to reflect that Parties, and not just Users, would be liable for DCC Charges. SEC Section J3 was also subsequently changed to reflect that Credit Support arrangements therefore applied to Parties. However, this change was not made to the defined terms in SEC Section A1.

Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

Therefore, it has been proposed that the relevant terms are amended to replace “Users” with “Parties” in the defined terms in SEC Section A1, within the Legal Text.

3.3 Path 2: Authority Determined

This modification has been progressed as a Path 2 – Authority Determined through the Modification Process. This is because it is likely to have a material impact on competition. This means the Change Board vote will form a recommendation to the Authority. The Authority will then be required to make a determination on whether to approve or reject SECMP0016.

Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

4. Impacts and Costs

This section sets out the expected impacts of SEMCP0016 on Parties and the DCC.

4.1 Party impacts

Compliant Parties will be exposed to increased socialised Unrecovered Bad Debt Payments if an Event of Default were to occur.

In order to help Parties to see how this modification may impact them a model[4], developed by the DCC was included in the Working Group Consultation to assist the Refinement Process. The model shows the residual risks to Parties if an Event of Default was to occur (in accordance with SEC Section M8), where there is a non-payment of a DCC invoice. The figures have been based on averages across three portfolio tiers and informs the approximate amount of Unrecovered Bad Debt Payments[5] for all Parties within each tier. The model is also based on the assumption that the DCC would socialise Unrecovered Bad Debt Payments to Compliant Parties two months after the Event of Default occurring.

The model also includes a "worked examples" tab that enabled Party's to input their relevant figures to calculate their current Credit Cover Requirement and what their Credit Cover Requirement would equal, based on the proposed calculation.

All SEC Parties with a VAR that exceeds the Credit Cover Threshold will now be required to obtain, and meet the cost of, a Credit Assessment Report even if the Party has a Recognised Credit Rating. The Credit Assessment Report will be needed as often as reasonably required and provided at least every 12 months.

The modification does not impact Parties with a Credit Cover Requirement below £2,000, as the Credit Cover Threshold provisions will remain the same.

4.2 DCC impacts

SECMP0016 will impact the DCC's business procedures, as minor changes will be required to the DCC's ongoing credit cover review process and methodology. The DCC have confirmed that this modification will not impact DCC systems.

The reduced amount of Credit Support held by the DCC, as a result of this modification, will increase the risk of a short-term cash flow shortfall. The DCC have notified that this is a small impact and there is no long-term risk to the financial stability of the DCC. This is because any Unrecovered Bad Debt is socialised across Compliant Parties.

There are no impmentation costs associated with the DCC making changes to it's business precures if SECMP0016 is approved, as reflected in the DCC Impact Assessment[6] response.

[4] SECMP0016 - DCC Credit Cover data model v4
[5] Pursuant to SEC Section K9.4
[6] DCC's Impact Assessment

Gemserv
Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

4.3 Other potential impacts

The following section sets out an overview of the other likely impacts arising from SECMP0016, as identified by the WG and the DCC.

Potential Impacts of SECMP0016	
Impact on Consumers	
There are no identified direct impacts on Consumers.	
SEC and subsidiary documents	
SEC Section A	SEC Section A1 will require amendments to: • remove the definition for Credit Cover Factor; • add definitions for Maximum Credit Value, Unsecured Credit Limit, and Unsecured Credit Factor; and • amend Credit Assessment Score and Value at Risk definitions.
SEC Section J	SEC Section J3 will require amendments to: • introduce the proposed new Credit Cover Requirement calculation; • change section numbering due to added sections; and • change necessary SEC Section J3 references to reflect new numbering.
SEC Subsidiary Documents	No impact
Other Industry Codes and Documents	
None.	
Greenhouse gas emissions	
No impact.	

4.4 Costs

The estimated central costs to implement this change will be limited to the Code Administrator time and effort to making the necessary amendments to the SEC and any supporting guidance documents, release the new versions of the SEC and guidance to SEC Parties, and the publication of them on the SEC Website. This is estimated at a maximum of **2 Man Days** effort equating to **£1200**[7].

[7] Based on a blended rate of £600 per day

5. Implementation

5.1 Recommended implementation approach

It has been noted that many Parties will be required to renew their Credit Support provisions at the start of the next Regulatory Year (1st April 2017) and it would be beneficial for Parties and the DCC if the implementation of SEMP0016 was aligned with this date. This is because it would prevent additional administration.

The DCC have indicated that they would require two months' lead time in order to implement the necessary changes in support of the SECMP0016 solution, if approved.

Implementation has therefore been proposed for **1st April 2017**.

Gemserv
Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

6. Working Group Discussions

This section contains a high level summary of the Working Group's (WG) discussion.

6.1 WG considerations of the current problem

The Proposer and WG highlighted that a Party's calculated Credit Cover Requirement will be working capital that is lodged as Credit Support in the form of a Bank Guarantee, a Letter of Credit, and/or a Cash Deposit. It was noted that this working capital cannot be used by a Party to invest in other areas of their business, for example in systems or people.

The WG suggested that high amounts of Credit Support could be a barrier to new entrants, because it will impact growth and could ultimately prevent a Party from entering the market. The WG also suggested that requiring Credit Support when it is not essential could increase the risk of a new entrant Party struggling financially, highlighting that the first few years of trading are often critical.

The WG also discussed Ofgem's "Best practice guidelines for gas and electricity network operator credit cover", noting the differences between these and the current SEC credit arrangements.

6.2 BEIS: Principles for financial arrangements in the SEC

The current Credit Cover arrangements in the SEC were consulted on in April 2012. The Department for Business, Energy, and Industrial Strategy (BEIS) informed the WG that the following principles were captured:

- pay now and dispute later;
- payments in arrears to be promptly made to ensure that the DCC has funds available to pay service providers in arrears;
- unsecured bad debt to be socialised across SEC Parties; and
- a robust approach to credit management to minimise scope for bad debt to crystallise.

It was noted that these principles remain valid.

6.3 Credit assessments

The WG discussed whether the Maximum Credit Value provided in a Credit Assessment would deliver an accurate level of assurance. Whilst noting that the value is not monetary and is determined in relation to a Party's entire company assets, it was highlighted that the amount represents what the Credit Assessor believes the Party is creditable for and it is a standard business mechanism for industries across the United Kingdom and Europe. It was also mentioned that the Credit Assessor will look at a number of aspects, including the company's payment history with a number of creditors, to establish whether the company settles invoiced charges on time.

6.4 Alternative solutions

The below table presents the possible alternatives that were considered during WG discussions and why they were deemed unsuitable for the SEC.

Gemserv
Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

Possible alternative solutions discussed	
Alternative solution	Why it was not progressed
Remove the Credit Cover Factor and subtract the Maximum Credit Value from the Value at Risk.	The WG expressed that considering both the value and the factors would add an extra level of risk assessment.
Setting a defined cap to the amount of Maximum Credit Value a Party is entitled to use. E.g. 75%.	The WG considered that there would be no way of agreeing and assessing a fair defined cap.
Setting a cap to the amount of Maximum Credit Value a Party is entitled to use based on number of years they have been trading.	The WG agreed that this solution would not solve the problem of barriers to market entry, which this modification is trying to prevent.
Good payment history incentive for Parties without a Recognised Credit Rating and Credit Assessment Score.	Whilst noting this was one of the outcomes from Ofgem's best practice guidelines, the WG felt that the current Credit Cover Threshold provisions offered margin for brand new market entrants without Credit Assessments. They also noted that bad payment history is recognised in SEC Section J3.4.
A centralised credit pool.	The WG considered that this would result in the Party's least at risk paying more Credit Support. It was also noted that this would increase operational and business costs.

6.5 Other industry codes

The original proposed calculation in the Modification Proposal Form was intended to align the SEC credit arrangements with the UNC. The UNC Transitional Principle Document Section 3.7 states "The Transporter will set the Users Unsecured Credit Limit no higher than the lower of the credit value recommended within the Independent Assessment and the value calculated by applying the Independent Assessment Score to the Transporter's Maximum Unsecured Credit Limit.". It was therefore established that the original proposed solution did not achieve this, because the UNC uses the lower value between the calculation and the Maximum Credit Value.

The WG were in agreement that any solution should reflect Ofgem's "Best practice guidelines for gas and electricity network operator credit cover".

6.6 Proposed solution

At the WG meeting held on 19th September 2016, the DCC presented a model informing the Credit Support provisions held based on the current credit arrangements, the original proposed solution, and an additional scenario. The current Credit Support is 72% of the total VAR for all Parties. It was highlighted that the original proposed solution detailed in the Modification Proposal Form reduced the Credit Support to 1% of the total VAR. The WG considered that 1% was too low and would excessively increase the financial risk from socialised

Unrecovered Bad Debt payments. It was agreed that any solution should seek to deliver an appropriate balance between the risk of socialised Unrecovered Bad Debt payments and the freeing up of Party's working capital.

The third additional scenario, which uses the calculation shown in the proposed solution section of this consultation, reduced the Credit Support to 31%. The WG considered this as an appropriate balance between risk and benefit and proceeded to refine the solution based on this. The Unsecured Credit Factors (UCFs) used in the additional scenario were originally based on the UNC. As the UNC operates on proportions of users Regulatory Asset Value (RAV) and the SEC does not, the UCFs had been doubled to reflect this. It was noted that if the percentages from the UNC, DCUSA, or CUSC were used, then the Credit Support held will also be reduced to 1% of the total VAR.

The WG then adjusted the UCFs to be apportioned in the same way as the UNC, DCUSA, and CUSC. This is so that the SEC would be broadly consistent with Ofgem's guidelines.

For example, 5A1 and 5A2/4A1 Dun and Bradstreet scores in the UNC determines the factors as 20% and 19%, respectively. The same scores originally in the model for the SEC, set the UCFs as 10% for both scores. This was then amended to 10% and 9.5%, respectively, and continued throughout the Credit Assessment Score table.

The Recognised Credit Rating UCFs were also amended to reflect the apportionments of Ofgem's guidelines. The original scenario presented to the group offered an incentive to Party's with a Standard and Poor's AAA rating (or equivalent) by setting the UCF as 100%. It was noted that amending this to ensure the UCF matrix reflects the ratios in Ofgem's guidelines, does not currently have a material impact, and it was agreed that the decrease should be consistent throughout.

6.7 Working Group Consultation responses and WG views against SEC Objectives

A summary of the responses received from the WG Consultation and the WG's discussions in relation to these responses, can be found in section 7 of this document. The detailed responses and discussions can be found in the **Attachment B - WG Consultation Responses**.

The WG's final views against the SEC Objectives can be found in section 7.6 of this document.

7. Views on SECMP0016

This section contains the views of the Proposer and the Working Group (WG) regarding the modification's benefits against the SEC Objectives.

7.1 Proposers and Working Group's initial views against SEC Objectives

General SEC Objective (d): the fourth General SEC Objective is to facilitate effective competition between person engaged in, or in Commercial Activities connected with, the Supply of Energy.

Prior to the WG Consultation, the Proposer and the WG believed that General SEC Objective (d) would be better facilitated by SECMP0016, if approved. This is because:

- The proposed solution reduces the working capital less well established market entrants would need to provide to the DCC in Credit Support, subsequently lowering the potential impact large amounts of required Credit Support would have on a Party's growth.
- This could in turn reduce barriers to market entry.
- The Credit Cover Requirement based on the proposed calculation is still proportionate to a Party's level of risk and does not adversely impact or benefit one Party Category over another.

7.2 Sub-Committee views

The changes proposed by SECMP0016 do not impact the Technical or Business Architecture, matters relating to the Security Architecture and/or provisions, or the Smart Metering Key Infrastructure (SMKI). Therefore, no Panel Sub-Committee remits are impacted by this change, and therefore no comments were provided by the TABASC, SSC or SMKI PMA.

7.3 Summary of the WG Consultation views

SECMP0016 was issued for WG Consultation on 5th October 2016. A total of eight responses, representing 14 Parties, were received.

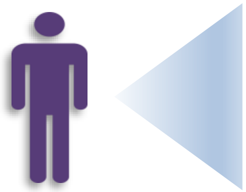
A summary of the Parties' views is below.

<u>Large Supplier Parties</u>

The three Large Supplier respondents noted that SECMP0016 proposes reducing the Credit Support held by the DCC to facilitate effective competition and reduce barriers to market entry.

Whilst supporting the reduction of Credit Support to 31% of total VAR, one respondent highlighted concerns regarding the complexity of the proposed solution. Firstly, they noted that the proposed solution will require Parties with a Recognised Credit Rating to also obtain and meet the cost of a Credit Assessment, which differs from other industry codes. Secondly, the Large Supplier Party believe that the proposed three new defined terms further complicate the SEC credit arrangements and questioned why a different approach to other codes had been taken.

The respondent also expressed their views on the proposed Unsecured Credit Factors. They believe that the proposed percentages were in some cases too "cliff edge". For



3 Responses
(representing 5 Parties)

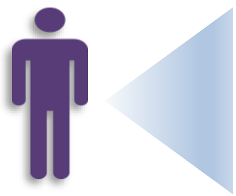
Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

example, the difference in default risk between a AA- and an A+ (Standard & Poor's) does not merit a difference between 50% and 20%. It was suggested that an approach based on the default rates that correspond with Recognised Credit Ratings or Credit Assessment Scores should be considered.

Regarding the legal drafting, the three respondents agreed that it delivers the intent of the proposed modification. However, one respondent also identified a further possible change regarding the obligation for Parties to provide additional Credit Support within two Working Days. It was noted that due to the timescales required to obtain a Letter of Credit, or even arrange Cash Deposit provisions, this time period is insufficient. Therefore, they suggested that this timescale be increased to five Working Days.

One Large Supplier respondent did not agree that the increased Unrecovered Bad Debt Payment in the Event of Default is acceptable, if SECMP0016 were to be approved. They noted that considerations need to be given to the fact that reduced Credit Cover Requirements could mean some suppliers are better able to "weather a financial storm" than other suppliers. Which in turn, could increase the risk in running the industry on close financial tolerances.

Small Supplier Parties

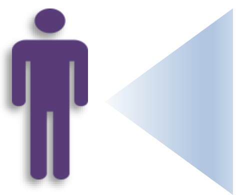


2 Responses
(representing 6 Parties)

Both Small Suppliers expressed their support of the Modification Proposal. They noted that the solution is well balanced in reducing Credit Support whilst managing the risk of socialising Unrecovered Bad Debt.

Whilst agreeing that the draft legal text delivers the intent of the proposed solution, one of the Small Supplier respondents proposed an amendment to the proposed new SEC Section J3.3A. They suggested that it should read "Each Party's Unsecured Credit Limit is equal to".

Network Parties



3 Responses
(representing 4 Parties)

Two of the Network respondents commented that the modification was a positive change. The Gas Network respondent noted that Ofgem's "Best practice guidelines for gas and electricity network operator credit cover" were considered to ensure best practice. The other Network Party did not have any comments.

The Gas Network respondent also noted that the DCC Charges for Gas Networks is currently set at zero, and so they are not currently directly impacted by SECMP0016. However, it was highlighted that once charging starts, Gas Networks will be required to provide Credit Support.

Other SEC Parties

No Other SEC Parties responded to this WG Consultation.

Gemserv
Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

7.4 Summary of the Working Group's considerations of the consultation responses

The final WG meeting was held on 28th October 2016. A summary of these discussions are below[8]. The detailed responses and discussions can be found in **Attachment B - WG Consultation Responses**.

Complexities to the proposed solution

The WG discussed the proposed new obligation for Parties with a Recognised Credit Rating to also obtain and meet the cost of a Credit Assessment. It was highlighted that the UNC, DCUSA, and CUSC determine an unsecured credit limit as a proportion of a Network's Regulatory Asset Value (RAV), whereas SECMP0016 proposes it be determined as a proportion of a Party's Maximum Credit Value. The DCC clarified that a Maximum Credit Value is not included as part of a Recognised Credit Rating (issued by organisations such as Standard & Poor's). Therefore, it was determined that there is not an alternate solution to obtain the Maximum Credit Value thereby avoiding this proposed obligation.

With regards to the Large Supplier's comments on added complexity to the SEC because of the three new defined terms, the WG agreed that the terms were necessary to deliver the intent of the modification.

Adjustments to the Unsecured Credit Factors

In response to the Large Supplier's views on the "cliff approach" to the proposed Unsecured Credit Factors, the WG decided not to make any further adjustments. The WG acknowledged that further analysis of default rates would be beneficial as a wider industry matter as it was highlighted that the factors in SECMP0016 had been aligned with the tiered approach recommended in Ofgem's "Best practice guidelines for gas and electricity network operator credit cover".

Credit Support timescales

The WG considered the further suggested change regarding timescales for Parties to provide Credit Support to the DCC. It was agreed that this should not be included in the scope of SECMP0016 and should be raised as a separate Modification Proposal.

Amendments to the legal text

The WG agreed to amend the legal text, as suggested by the Small Supplier Party. The revision to the legal text is included in **Attachment A – SECMP0016 Legal Text**.

Increased risk to Event of Default

The WG acknowledged the Large Supplier's response in relation to the increased risk of an Event of Default due to "running parts of the industry on such close financial tolerances". However, the WG noted that this concept generally applies to all businesses.

[8] The detailed responses and discussions can be found in the Modification Report – Attachment B - WG Consultation Responses

7.5 The Proposer's and WG's final views against the SEC Objectives

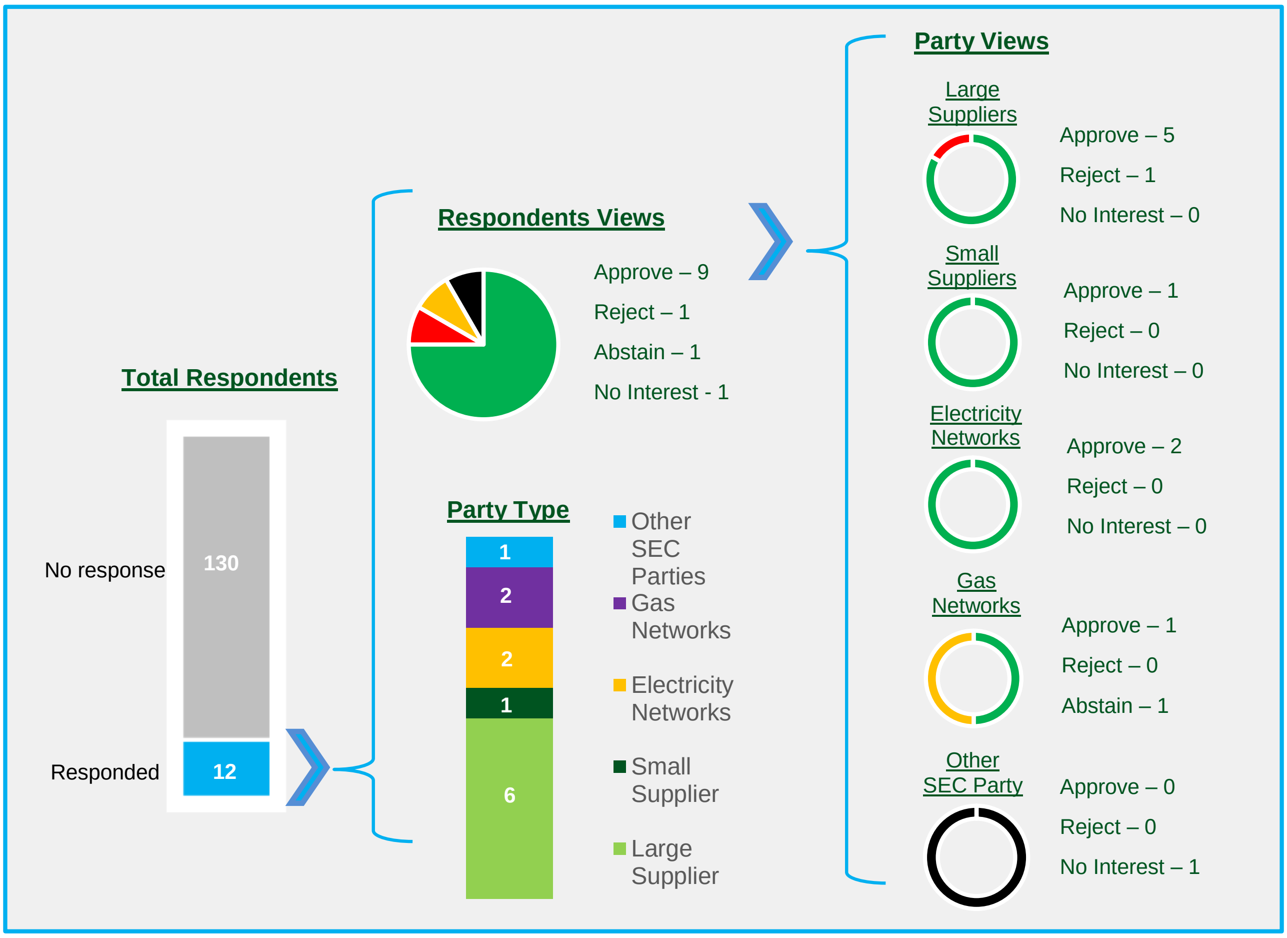
Following the Refinement Process, the WG Consultation, and the WG's consideration of the consultation responses received, the Proposer and the WG agreed that their views against the SEC Objectives are unchanged from the initial views (as per section 7.1 of this document).

8. Modification Report Consultation Responses

This section summarises the responses received to the Modification Report Consultation. 12 consultation responses, representing a total of 14 SEC Parties[9], replied to the Modification Report Consultation.

The full list of represented SEC Parties and the responses are provided in **Attachment C – MR Consultation Responses**.

8.1 Summary of Responses



[9] Out of a total of 184 SEC Parties.

8.2 Summary of views against the SEC Objectives

Summary of Large Suppliers' views for and against SECMP0016		
SEC Objectives	**Benefit(s)**	**Drawback(s)**
Objective (a)	None	One Large Supplier believed that the modification is detrimental to the first General SEC Objective[10], because it increases the risk of a defaulting SEC Party having insufficient Credit Support to cover its costs. This could then lead to the inefficient socialisation of outstanding charges. They also noted that the threat of Parties defaulting remains, highlighting recent industry events.
Objective (d)	All but one Large Supplier agreed that SECMP0016 better facilitates (d)[11] because: • it decreases the amount of working capital small or independent supplier will have to lodge as Credit Support, so it increases their ability to invest in their business; • removes a current barrier to market entry; • the increase to the level of residual risk overall is not disproportionately allocated and the relative level of risk for each Party remains roughly in the same proportion as the current credit arrangements.	One Large Supplier noted that the SEC credit arrangements include the principle of a Credit Cover Threshold and that this should mitigate against barriers to entry. They, therefore, considered the effect on this Objective to be neutral.
Summary of Small Suppliers' views for and against SECMP0016		
SEC Objectives	**Benefit(s)**	**Drawback(s)**
Objective (d)	The Small Supplier agreed with the Proposer's and WG's view.	None
Summary of Electricity Network Parties' views for and against SECMP0016		
SEC Objectives	**Benefit(s)**	**Drawback(s)**
Objective (d)	The Electricity Network Parties agreed with the Proposer's and WG's view	None

[10] SEC Section C1.1 – the first General SEC Objective is to facilitate the efficient provision, installation, and operation, as well as interoperability, of Smart Metering Systems at Energy Consumers' premises within Great Britain.
[11] SEC Section C1.1 - the fourth General SEC Objective is to facilitate effective competition between persons engaged in, or in Commercial Activities connected with, the Supply of Energy.

Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

Summary of Gas Network Parties' views for and against SECMP0016		
SEC Objectives	**Benefit(s)**	**Drawback(s)**
Objective (d)	One Gas Network Party agreed that SECMP0016 better facilitates (d) because: • it removes a potential barrier to entry; • it reduces the risk of financial pressure for Parties who have to lodge large amounts of Credit Support; • it does not significantly increase the risk to the wider community of socialised bad debt; and • it aligns the SEC with the approach used in other industry codes.	None

9. Change Board Decision

9.1 Deferral?

The Change Board unanimously agreed that SECMP0016 should not be sent back to the SEC Panel for further clarification or analysis.

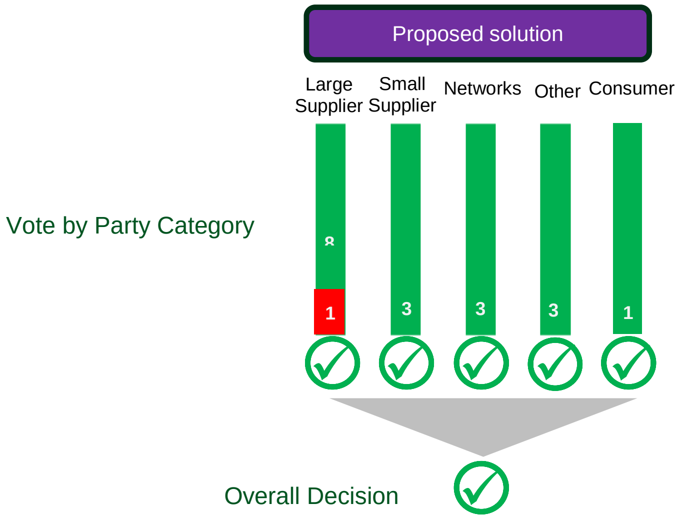
9.2 Approve SECMP0016

The Change Board voted to approve SECMP0016. They believed the modification better facilitated:

- 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;
- SEC Objective (d), facilitating the effective competition between persons engaged in, or in Commercial Activities connected with, the Supply of Energy; and
- SEC Objective (g), facilitating the efficient and transparent administration and implementation of this Code.

One Large Supplier voted to reject the modification as they believed that it was detrimental to SEC Objective (a). They also believed the existing arrangements that contain a Credit Cover Threshold mitigates any impact on competition and so felt this modification was neutral against Objective (d).

Details of voting and views by Party Category is provided in **Attachment D**. A summary of the Change Board’s views against the applicable SEC Objectives can be found below.



Summary of Change Board views on SECMP0016		
SEC Objective	**Benefit**	**Drawback**
Objective (a)	• Increases efficiencies of the provision and operation of Smart Metering Systems in Great Britain.	• Increases the risk of a defaulting SEC Party not having adequate Credit Support in place to cover their costs.

Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

Summary of Change Board views on SECMP0016		
SEC Objective	**Benefit**	**Drawback**
		• Increases the Socialised Bad Debt Payments across Parties if an Event of Default was to occur. • Events of Default are still a current risk, noting the recent defaulting supplier.
Objective (d)	• Reduces the amount of working capital Parties have to lodge as Credit Support, which could reduce financial pressure and increase the ability for Parties to invest in their business; • Reduces barriers to market entry. • Aligns the SEC with Ofgem's best practice guidelines. • Aligns the SEC with other Industry Codes. • the increase to the level of residual risk overall is not disproportionately allocated and the relative level of risk for each Party remains roughly in the same proportion as the current credit arrangements.	• The current Credit Cover Threshold should mitigate against barriers to entry and so the effects of SECMP0016 on the fourth SEC Objective are neutral.
Objective (g)	• Aligning the SEC with other Industry Codes will improve the efficiency and transparency of the SEC.	None

9.3 Change Board considerations

A Large Supplier Member noted that SECMP0016 was raised with the consideration of it benefitting new and less established market entrants, however, only one Small Supplier responded to the Modification Report Consultation. Whilst acknowledging the lack of responses, a Small Supplier Member highlighted that Parties in this category may not have the resources readily available in order to respond to Modification Report Consultations.

Appendix 1 – Working Group Details

Working Group Membership

During the initial consideration of SECMP0016, the Panel agreed for the modification to be allocated to Working Group 5 during the Refinement Process.

The following table contains a list of the Voting Working Group 5 Members and the Working Group meetings they each attended to discuss SECMP0016.

Working Group Membership and Attendance			
Working Group Member	Meeting 1 – 5th August 2016	Meeting 2 – 19th September 2016	Meeting 3 – 28th October 2016
Andy Knowles (Utilita)	✓		✓
Duncan Carter (Cooperative Energy)	✓	✓	✓
Elias Hanna (Landis + Gyr)		✓	✓
Jeremy Guard (First Utility) (Proposer)	✓	✓	✓
Paul Saker (EDF Energy)	✓	✓	✓
Sue Davies (Wales and West Utilities)	✓	✓	✓
Simon Trivella (British Gas)			✓

Working Group Terms of Reference

To meet the requirements of the Refinement Process set out in SEC Sections D6.8 - D6.14, the Panel agreed standard Terms of Reference (ToR) and identified supplementary matters for the Working Group to consider in order to fully assess the Modification Proposal.

The below table contains these questions and highlighted the subsequent sections in this document where they have been addressed.

Working Group ToR – supplementary matters to consider	
Question	Section(s) of this document
What is the materiality of the issue?	Section 2 – Why Change?
Is the solution proposed in this SECMP0016 more efficient than the current arrangement?	Section 7 – Views on SECMP0016
Are there other deficiencies in the current solution that are addressed by SECMP0016?	Section 2 – Why Change? Section 7 – Views on SECMP0016

Working Group ToR – supplementary matters to consider	
Question	Section(s) of this document
What are the systems impacts for the DCC?	Section 4 – Impacts and Costs (4.2 - DCC impacts)
What was the methodology and reasoning behind the current Credit Support arrangements?	Section 6 – Working Group Discussions (6.2 – BEIS: Principles…)
What is the rough order of magnitude in terms of forecasted Credit Support?	Section 4 – Impacts and Costs (4.1 - Party impacts)
What would be the impacts if a SEC Party, with a reduced Credit Cover Requirement as a result of this Modification Proposal, was to default?	Section 4 – Impacts and Costs (4.1 - Party impacts)
What are the costs and lead times to introduce the solution in this SECMP0016?	Section 4 – Impacts and Costs (4.4 - Costs) Section 5 – Implementation
Is the implementation timetable appropriate?	Section 5 – Implementation Section 7 – Views on SECMP0016
Are Consumers positively or negatively impacted by the Proposed solutions and to what extent?	Section 4 – Impacts and Costs (4.3 – Other potential impacts)
What Modification Implementation Testing is required to implement the Proposed Modification?	Section 4 – Impacts and Costs
What are the implementation steps and activities required to implement the Proposed (or an Alternative) Solution(s)?	Section 5 – Implementation
Have the views of the relevant Panel Sub-Committee been taken into account?	Section 7 – Views on SECMP0016 (7.2 – Sub-Committee views)
Has the Refinement Process identified any potential reason that this Modification (or its Alternatives) may require EC Notification (noting that the Authority will determine if any such Notification is pursued)?	Section 3 – Proposed Solution (3.3 Path 2: Authority Determined) Section 5 – Implementation
What are Ofgem's guidelines on cross industry credit arrangements?	Section 2 – Why Change? (2.2 – What is the issue?) Section 6 – Working Group Discussions

Appendix 2 – Glossary and References

Glossary		
Acronym	Term	Description
BEIS	The Department for Business, Energy, and Industrial Strategy	
CCF	Credit Cover Factor	A percentage determined by the Party's (or the provider of the Party's Parent Company Guarantee) Recognised Credit Rating or Credit Assessment Score.
CUSC	Connection and Use of Systems Code	CUSC constitutes the contractual framework for connection to, and use of, National Grid's high voltage transmission system.
DCC	Data Communications Company	
DCUSA	Distribution Connection and Use of System Agreement	A multi-party contract between licensed electricity distributors, suppliers and generators in Great Britain concerned with the use of the electricity distribution system.
RAV	Regulatory Asset Value	This is the value of a Party's regulated assets as published by the Authority.
UNC	Uniform Network Code	The commercial regime which underpins the gas industry in Great Britain.
VAR	Value at Risk	A Party's Value at Risk is the sum of the unpaid Charges (including VAT) invoiced to the Party and the estimated Charges the Party are likely to incur in the period until the next invoice.
	Working Capital Adjustment/Cycle	Currently 1.4. This accounts for the working capital cycle (invoices being settled eight Working Days after they have been issued) and takes into account a Parties' possible account growth, ensuring that each Party has sufficient Credit Support in place.

References

The following table contains any useful links relevant to this change or referenced in this document.

Links and References	
Description	Link
SECMP0016 – Modification Proposal Form v1.0	https://www.smartenergycodecompany.co.uk/docs/default-source/modificationfiles/secmp0016/secmp0016---modification-proposal-form-v1-0.pdf?sfvrsn=0
SECMP0016 – Initial Modification Report v1.0	https://www.smartenergycodecompany.co.uk/docs/default-source/modificationfiles/secmp0016/secmp0016-initial-modification-report.pdf?sfvrsn=0
SECMP0016 – Working Group Consultation v1.0	https://www.smartenergycodecompany.co.uk/docs/default-source/modificationfiles/secmp0016/secmp0016---working-group-consultation-v1.pdf?sfvrsn=2

Administered by Gemserv
8 Fenchurch Place, London EC3M 4AJ

Links and References	
Description	Link
SECMP0016 – DCC Impact Assessment v1.1	https://www.smartenergycodecompany.co.uk/docs/default-source/modificationfiles/secmp0016/secmp0016---dcc-impact-assessment-v1-1-final.pdf?sfvrsn=0
Ofgem's "Best practice guidelines for gas and electricity network operator credit cover"	https://www.ofgem.gov.uk/ofgem-publications/61607/9791-5805.pdf
Connection and Use of System Agreement (CUSC)	http://www2.nationalgrid.com/uk/industry-information/electricity-codes/cusc/the-cusc/
Distribution Connection and Use of System Agreement (DCUSA)	https://www.dcusa.co.uk/SitePages/Documents/DCUSA-Document.aspx
Uniform Network Code (UNC) Transportation Principal Document (TPD)	http://www.gasgovernance.co.uk/TPD