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DP159

'Credit Cover Review'

Modification Report

Version 0.2

18 May 2021

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About this document

This document is a draft Modification Report. It currently sets out the background, issue, and progression timetable for this modification, along with any relevant discussions, views and conclusions. This document will be updated as this modification progresses.

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Summary

This proposal has been raised by Sasha Townsend from the Data Communications Company (DCC).

The DCC and the Smart Energy Code (SEC) Panel have reviewed SEC Section J3 ‘Credit Cover’ and have identified several areas that would benefit from further clarification. There has been some misinterpretation of the current SEC legal text outlining the Credit Cover processes. This has led to increased risk of cost socialisation. The DCC and the Panel propose to update Credit Cover processes to clarify obligations on parties and reduce the opportunity for misinterpretation, as well as to address inefficiencies.

Issue

What are the current arrangements?

Credit Cover is an amount which a SEC Party pays to the DCC, to be used if the Party cannot pay its standard monthly payment for DCC charges.

Credit Cover pays for a Party’s outstanding debts up to the value of the Credit Cover in place. If a Party does not have Credit Cover and ceases to trade, unpaid DCC charges are usually socialised amongst SEC Parties if they cannot be recovered by Administrators, which negatively impacts the industry.

If a Party does not provide the required Credit Cover, it will enter an Event of Default under the SEC (Section M8.1). This can negatively impact a Party as there are several actions that the SEC Panel can take to help resolve the Default as quickly as possible. This includes notifying other SEC Parties that the Party is in Default, suspension of several rights, and the suspension of core communication services. It is therefore important that a Party complies with its Credit Cover obligation.

Parties that incur DCC Charges are required to put in place a form of Credit Support[1] if their Credit Cover Requirement[2] is over the Credit Cover Threshold[3]. The amount of Credit Support each Party is required to provide and the process of managing Credit Cover is currently set out in SEC Section J3.

If a Party must provide Credit Support, it may do so by providing one or more of the following three options as per Section J3.1:

- a Bank Guarantee;
- a Letter of Credit; and/or
- a Cash Deposit.

[1] means one or more of a Bank Guarantee, Cash Deposit and/or Letter of Credit procured by a User pursuant to Section J3 (Credit Cover).

[2] A Party’s Value at Risk minus the Party’s Unsecured Credit Limit.

[3] means, in respect of each Regulatory Year, £2,000, multiplied by the Consumer Prices Index for the October preceding the start of that Regulatory Year, divided by the Consumer Prices Index for October 2014. The relevant amount will be rounded to the nearest pound.

What is the issue?

Following the review of SEC Section J3 the predominant issues identified are set out in the following sections:

Calculation of Credit Cover Requirement

Currently, SEC Section J3.2 obliges the DCC to calculate each Party's Credit Cover Requirement "from time to time (and at least once a week)". The DCC considers that as Credit Cover is partly calculated using monthly invoices, this means that when calculated weekly, a Party's Credit Cover Requirement would increase over the month and then decrease again upon payment of their invoice. The DCC notes that this method is labour intensive for both the DCC and SEC Parties as this creates the need to transfer funds between the DCC and Parties on a weekly basis, noting the two-day payment terms.

Furthermore, current processes leave the Credit Cover position open to risk as if a Party is struggling to make payment, the situation may result in Credit Cover being returned and then the Party may not be able replenish it again ahead of being invoiced.

The Proposer of MP095 'Alignment of SEC Credit Cover' has been made aware of this Draft Proposal and has decided to keep MP095 on hold while Credit Cover processes are reviewed. The Proposer will be kept up to date as DP159 progresses.

Value at Risk

SEC Section J3.3 sets out that the Value at Risk shall be calculated using 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. The DCC notes that the charges not yet paid by the Party may include Explicit Charges which may not be regular charges included in a SEC Party's invoice. This may mean that where Parties are invoiced the Explicit Charges for a given service as a one-off one month, their Credit Cover Requirement may increase the following month and then reduce again when they no longer require the relevant services. Again, this results in the need to transfer funds between the DCC and Parties and could be deemed inefficient. The DCC also notes that this may negatively impact smaller Parties' cashflow. This would be because they would request a larger invoice than usual plus the same cash as Credit Cover in a short space of time, when it does not limit the risk of non-payment.

Parent Company Guarantees

The DCC considers that the current requirements surrounding Parent Company Guarantees (PCGs) are ambiguous and may cause confusion. Following legal advice from both the DCC and the SEC Lawyer, it was clarified that the correct interpretation is as follows:

- A PCG is not considered a form of Credit Cover.

SEC
Smart Energy Code

- When a PCG is provided by a Parent Company, the Party's Credit Cover Requirement can be calculated using the Parent Company's Maximum Credit Value[4] and its Unsecured Credit Factor.
- Where no PCG has been provided, the Party's Credit Cover Requirement cannot be calculated by the Parent Company's Maximum Credit Value and Unsecured Credit Factor. In these circumstances, the Credit Cover Requirement is calculated based on the Party's own Maximum Credit Value and Unsecured Credit Factor.

This is currently not clear within the SEC.

Views of the SEC Panel

The Panel considers that the use of Parent Company guarantees in the calculation of SEC Party Credit Cover requirements is not sufficiently robust. This exposes all SEC Parties to potential financial risk in the event of a Party going into Payment Default. Specifically, the Credit Cover calculations allow Parent Company Guarantees to apply to both the Party's Maximum Credit Value (SEC Section J3.3B) and the Party's Unsecured Credit Factor (SEC Section J3.5). This can have the effect of reducing the requirement for Credit Support to zero.

Unsecured Credit Factor

Currently, SEC Section J3.8 sets out that "each Party shall be entitled to choose which of the listed credit assessment companies, and which of the listed products, is used for the purposes of establishing its Credit Assessment Score[5] and Maximum Credit Value". The DCC considers that this may enable Parties to choose an option that results in a lower Credit Cover Requirement and notes that this limits the DCC's control over the Credit Cover process. The DCC has also noted that this approach poses a risk due to the outcomes of the Credit Assessment Score and Maximum Credit Value being altered to reduce or remove Credit Cover altogether.

Credit Assessment Report

SEC Section J3.9 sets out the requirements for obtaining a Credit Assessment Report. This includes stating that revised Maximum Credit Value and Credit Assessment Scores shall be obtained as often as the Party "reasonably requires and at least once every 12 months". The DCC also considers that this limits the DCC's control over the Credit Cover process and increases the risk of inadequate Credit Cover Requirements. The DCC has also identified that the table in SEC Section J3.8 does not currently list all possible options for Credit Assessment Scores (and therefore Unsecured Credit Factors).

Increase or Decrease in Credit Cover Requirements

SEC Section J3.12 states that additions and reductions in Credit Support can be achieved by amending the terms of existing Credit Support or exchanging Credit Support. The DCC notes that for

[4] the amount recommended by one of the credit assessment companies identified in Section J3.8 as the maximum amount a creditor should have outstanding to the Party at any one time.

[5] means, in respect of a Party, a credit assessment score in respect of that Party procured from one of the credit assessment companies named in Section J3.8 (Party's Unsecured Credit Factor).

bank related cover, terms could be amended. However, the DCC questions what the exchanging refers to. This is because shortfall under Bank Guarantee will likely result in a Cash Deposit being issued, due to the two Working Day timeframe referenced in SEC Section J3.10. This may later be amended, and the Cash Deposit will be repaid in accordance with SEC Section J3.11.

SEC Section J3.13 states that where a Bank Guarantee, Letter of Credit or Parent Company Guarantee provided ceases to satisfy the requirements of the definitions then the DCC shall return the relevant document to the Party within five Working Days after a request to do so. The DCC questions whether the requirement is to return the original documentation via post.

Use of Credit Support

SEC Section J3.16 sets out the requirements for drawing on Credit Support if invoices are unpaid. Currently the section states that the DCC can use Credit Support on the Working Day following the serving of a Notification of Payment Failure. The DCC considers that this timeframe could result in too many cash movements between trading accounts.

Letters of Credit and Bank Guarantees

The DCC considers that the current requirement to provide notice to Parties that their Letter of Credit or Bank Guarantee is due to expire in 20 Working Days as set out in SEC Section J3.22, is not long enough for the Party to put a replacement in place.

SEC Party Confidentiality

The Panel considers that the confidentiality provisions within the SEC, in relation to the sharing of SEC Party information, should be further clarified and updated to facilitate discussions and decision-making by SEC Panel. This relates specifically to Event of Default cases, and the calculation of Credit Cover. At present the DCC seeks SEC Party consent before sharing such data with the Panel, which can delay the process or impede the Panel in fulfilling its role.

The Panel believes the confidentiality provisions within SEC Section M4.7 should be updated, to facilitate the more expedient sharing of SEC Party information with SEC Panel.

What is the impact this is having?

SEC Parties and the DCC have highlighted that the high level of complexity surrounding the SEC's Credit Cover processes can lead to confusion, and there have been instances where SEC Parties and the DCC have interpreted certain requirements differently. This has led to scenarios where the incorrect level of Credit Cover has been provided and inefficiencies have become apparent. The DCC and the Panel wish to clarify the Credit Cover process to remove opportunities for misinterpretation that may lead to exposing SEC Parties to a heightened risk of cost socialisation.

There have been two issues recently that have stemmed from these misinterpretations:

- The DCC has previously misinterpreted the SEC and considered that a PCG equated to a Letter of Credit. This resulted in four Parties only having a PCG in place, and not Credit Cover. Of the four Parties, one Party has subsequently failed, and the DCC now needs to reclaim charges from the Parent Company, rather than from the failed Party's Credit Cover. It is yet to be determined if this has been successful.

- As per the SEC, the DCC has accepted PCGs from businesses outside the UK, and, in the case of one Party, accepted a PCG from an Affiliate, in order for the Party to reduce its Credit Cover requirement. The Panel, however, has stated that acceptance of PCGs from non-UK businesses causes concern, in terms of the Panel's ability to successfully claim on them, as does the Party's ability to switch the PCG to an Affiliate.

Impact on consumers

Misinterpretation of the Credit Cover process can heighten the risk of cost socialisation. If a SEC Party ceases to trade and does not have an adequate level of Credit Cover, the costs will be socialised amongst all other SEC Parties. Ultimately, if a SEC Party must pay socialised cost charges, the funds will be borne by the Consumer.

Assessment of the proposal

Observations on the issue

The proposal was presented to the Change Sub-Committee (CSC) in April 2021 for initial comment. CSC members were supportive of the proposal and provided no further comment. The proposal was also presented to the other SEC Sub-Committees. Each SEC Sub-Committee was happy for the proposal to progress and provided no further comments on the issue. No Sub-Committees requested updates throughout the proposal's progression.

Further potential inefficiencies identified

During the Development Stage, the Panel and SECAS discussed the obligation in SEC Section J3.16:

Use of Credit Support

J3.16 Where a Party fails to pay the Charges set out in an Invoice addressed to that Party by the Due Date for that Invoice, and where the DCC has issued a notice to that Party pursuant to Section J2.1 (Notification of Payment Failure), the DCC shall (in addition to any other remedies available to it) on the Working Day following service of such notice:

a) claim an amount equal to the unpaid Charges plus interest (or, if lower, as much as is available to be claimed) under any Bank Guarantee or Letter of Credit provided on behalf of that Party;

b) remove an amount equal to the unpaid Charges plus interest (or, if lower, as much as is available to be removed) from any Cash Deposit account; or

c) undertake a combination of the above in respect of a total amount equal to the unpaid Charges plus interest (or, if lower, as much as is available to be claimed or removed).

The Panel and SECAS believe that it may be beneficial for the DCC to have more flexibility regarding when it can draw on Credit Cover when a Party has failed to pay its DCC Charges. This would require lengthening the current same Working Day as set out in Section J3.16.

The main driver behind this is for the DCC to draw on Credit Cover when it deems necessary (when it is clear the defaulting Party will be unable to pay its debt). This will mean that the Party will enter into payment default rather than Credit Cover default, which is deemed beneficial as it will enable the DCC to undertake actions that are otherwise not available when a Party is in Credit Cover default. This is particularly relevant to issuing a Statutory Demand, which is possible when pursuing debt (and not Credit Cover) and threatens legal action if payment is not made within 21 Calendar Days.

Appendix 1: Progression timetable

This Draft Proposal will be taken to the CSC for final comments and recommendations on 25 May 2021 before proceeding to the SEC Panel on 18 June 2021. Once the proposal enters the Refinement Process SECAS will work with the Proposer to develop the solution.

Timetable	
Event/Action	**Date**
Draft Proposal raised	13 Apr 2021
Presented to CSC for initial comment	27 Apr 2021
Presented to CSC for final comment and recommendations	25 May 2021
Panel converts Draft Proposal to Modification Proposal	18 Jun 2021
SECAS to develop solution with the Proposer	Jun 2021
SECAS to engage with SEC Lawyer to refine the Proposed Solution	Jul 2021
Modification discussed with Working Group	4 Aug 2021
Refinement Consultation	9 Aug – 27 Aug 2021
Modification discussed with Working Group	6 Sep 2021
Update Panel	17 Sep 2021

Appendix 2: Glossary

This table lists all the acronyms used in this document and the full term they are an abbreviation for.

Glossary	
Acronym	**Full term**
CSC	Change Sub-Committee
DCC	Data Communications Company
PCG	Parent Company Guarantee
SEC	Smart Energy Code
SECAS	Smart Energy Code Administrator and Secretariat