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MP159 'Credit Cover Review'

Modification Report

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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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This document also has one annex:

- **Annex A** contains the redlined changes to the Smart Energy Code (SEC) required to deliver the Proposed Solution.

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1. Summary

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

The DCC and the 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.

The Proposed Solution is to address the identified inefficiencies within current process and also to rewrite certain clauses in Plain English to mitigate the risk of misinterpretation by SEC Parties and the DCC. This modification will impact Large and Small Suppliers, Network Parties and the DCC. There are no DCC costs to implement this modification. SEC Party costs will be gathered during the Refinement Consultation. MP159 is currently targeted for the June 2022 SEC Release. This is an Authority Determined Modification.

2. 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 does not 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 Support¹ if their Credit Cover Requirement² is over the Credit Cover Threshold³. 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;

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.

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

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 to 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 MP095 Proposer will be kept up to date as this modification 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. Legal advice from both the DCC and the SEC Lawyer clarified that the correct interpretation is as follows:

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

- 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 Value⁴ 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 PCGs 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 Score⁵ 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. The Bank Guarantee or Letter of Credit 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, if requested, 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. This is mainly due to Credit Cover being drawn on and then the Party pays their invoice shortly after. The invoice is paid to the DCC trade account and not the Credit Cover account.

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.

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 had subsequently failed, and the DCC had to reclaim charges from the Parent Company, rather than from the failed Party's Credit Cover. The DCC have confirmed that this has since been recovered in full.
- 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.

3. Solution

Proposed Solution

The Proposed Solution will result in a significant review of Credit Cover arrangements captured within SEC Section J 'Charges'. The Smart Energy Code Administrator and Secretariat (SECAS) will rewrite the clauses in Plain English to mitigate the risk of misinterpretation by Parties and the DCC. SEC Section M 'General' will also be amended to update confidentiality provisions to facilitate the more expedient sharing of SEC Party information with SEC Panel.

A summary of the proposed changes to Credit Cover requirements can be found below:

Calculation of Credit Cover Requirement

The calculation of Credit Cover Requirement will be calculated at least monthly as opposed to weekly. This is deemed to be more efficient as it will prevent Parties and the DCC transferring money on a weekly basis. Furthermore, DCC's invoices are generated monthly and so this amendment would fall in line with this process.

Value at Risk

It is proposed that Explicit Charges will be excluded from the Value at Risk calculation. The new calculation will be 115% of the charges (inclusive of Value Added Tax (VAT)) set out in the most recently produced invoice (minus Explicit Charges).

Parent Company Guarantees

The legal text will now explicitly state that Parent Company Guarantees cannot be used explicitly as a form of Credit Cover. The text will clarify to Parties that a Parent Company Guarantee may reduce the level of Credit Cover required. Further clarifications will be added around the use of Parent Company Guarantees.

Unsecured Credit Factor

The DCC have advised that obtaining a Recognised Credit Rating from DBRS (also known as Dominion Bond Rating Service or DBRS Morningstar) can be difficult, and so wish to remove it from the list of credit rating agencies.

Credit Assessment Report

To reduce the risk of an inadequate level of Credit Cover, Credit Assessment Scores shall be obtained at least monthly as opposed to annually. The DCC also suggest that only one credit assessment company is used for all SEC Parties for consistency (instead of Parties having the choice of five individual companies). The DCC recommend using Dun & Bradstreet.

Increase or Decrease in Credit Cover Requirements

SECAS will amend this section so that if a Party's level of Credit Cover is less than what has been calculated for that month (by more than £100), the Party will have two Working Days to provide the additional funds. If the Credit Support is 10% higher than what is required, the DCC will return the excess funds within five Working Days following a request from the Party.

Use of Credit Support

The legal text will be updated to extend the current period whereby the DCC can draw down on Credit Cover following an unpaid invoice from one Working Day to five Working Days. This will reduce overly frequent money transfers between Parties and the DCC.

Letters of Credit and Bank Guarantees

The DCC have stated that they will send an informal reminder to the Party the month before their Letter of Credit or Bank Guarantee is set to expire. This will provide a sufficient timeframe for the relevant Party to make the necessary arrangements to renew their soon to expire Letter of Credit or Bank Guarantee. This will not require a change to the legal text.

4. Impacts

This section summarises the impacts that would arise from the implementation of this modification.

SEC Parties

SEC Party Categories impacted			
✓	Large Suppliers	✓	Small Suppliers
✓	Electricity Network Operators	✓	Gas Network Operators
	Other SEC Parties	✓	DCC

Breakdown of Other SEC Party types impacted			
	Shared Resource Providers		Meter Installers
	Device Manufacturers		Flexibility Providers

This modification will impact SEC Parties that are currently subject to the provision of Credit Cover. The DCC will also be impacted by MP159 as there will be changes to current processes relating to Credit Cover.

DCC System

This modification will have no impact on DCC Systems.

SEC and subsidiary documents

The following parts of the SEC will be impacted:

- Section A 'Definitions and Interpretations'
- Section J 'Charges'
- Section M 'General'

The changes to the SEC required to deliver the proposed solution can be found in Annex A.

Consumers

This modification will have no impact on consumers.

Other industry Codes

This modification will have no impact on other industry Codes.

Greenhouse gas emissions

This modification will have no impact on greenhouse gas emissions.

5. Costs

DCC costs

The DCC will not incur any costs as a result of implementation of this modification.

SECAS costs

The estimated SECAS implementation cost to implement this as a stand-alone modification is one day of effort, amounting to approximately £600. This cost will be reassessed when combining this modification in a scheduled SEC Release. The activities needed to be undertaken for this are:

- Updating the SEC and releasing the new version to the industry.

SEC Party costs

Estimated SEC Party costs will be provided through the Refinement Consultation.

6. Implementation approach

Recommended implementation approach

SECAS is recommending an implementation date of:

- **30 June 2022** (June 2022 SEC Release) if a decision to approve is received on or before 16 June 2022; or
- **3 November 2022** (November 2022 SEC Release) if a decision to approve is received after 16 June 2022 but on or before 20 October 2022.

As MP159 will only involve legal text changes, the modification is expected to be implemented ten Working Days after decision. This may however change if respondents state in the Refinement Consultation that they require a longer lead time to implement changes to Credit Cover requirements. please note that this is an Authority Determined modification.

7. 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 as were the Sub-Committees. SECAS presented the proposal to the CSC in May 2021 for final comments. The CSC was supportive of the Draft Proposal being converted into a Modification Proposal and proceeding to the Refinement Process.

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.

Views of the Panel

SECAS presented the proposal to the Panel on 18 June 2021 for conversion into a Modification Proposal and to enter the Refinement Process. The Panel commented that it would be advantageous if the Proposed Solution is consistent with other industry Codes.

Views of the Working Group

The Proposer added further detail to elements of the Proposed Solution. In regard to the use of Credit Support, they suggested that it would be beneficial to align the new requirement with the same timeframe of Events of Default. The Proposer commented that it is common for customers to pay invoices between the invoice due date and before the Event of Default notification (three Working Days after the late payment notice (four Working Days after the invoice due date)). This causes confusion for Parties as they will have their Credit Cover drawn upon by the DCC, then will make payment of the invoice and will then have to top up their Credit Cover Requirement. The Proposer recommend that Credit Cover is only drawn upon when a Party enters default for failing to pay its DCC Charges.

Furthermore, in relation to the DCC extending the notification to a Party whose Letter of Credit or Bank Guarantee is set to expire to 30 Working Days, the Proposer advised that they should instead send an informal reminder to the Party the month prior. This will not require an amendment to the SEC.

During the Development Stage the Panel requested that SECAS explored SEC Party confidentiality in relation to Events of Default. During the Working Group, the Proposer requested clarity on potential changes to the dataset disclosed to the Panel when an Event of Default occurs. It recommended the invoice value and Party name. the Panel withdrew this request following the meeting.

SECAS informed the Working Group that the Refinement Consultation will be extended to 20 Working Days to allow Parties to forward on the relevant documents to their finance teams in order to provide feedback on the modification.

Appendix 1: Progression timetable

SECAS will issue an extended Refinement Consultation to allow Parties to consult with their finance teams. SECAS will review the responses with the Working Group before proceeding to the CSC under the recommendation that MP159 enters the Report Phase.

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 - Sep 2021
Modification discussed with Working Group	6 Oct 2021
SECAS to engage with SEC Lawyer to refine the Proposed Solution	Oct 2021
Refinement Consultation	23 Nov – 21 Dec 2021
Modification discussed with Working Group	5 Jan 2022
Modification Report approved by CSC	18 Jan 2022
Modification Report Consultation	19 Jan – 8 Feb 2022
Change Board Vote	23 Feb 2022
Authority Decision	Apr 2022

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
DBRS	Dominion Bond Rating Service
DCC	Data Communications Company
PCG	Parent Company Guarantee
SEC	Smart Energy Code
SECAS	Smart Energy Code Administrator and Secretariat
VAT	Value Added Tax