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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 sets out the background, issue, and progression timetable for this modification, along with any relevant discussions, views and conclusions.

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This document also has two annexes:

- **Annex A** contains the redlined changes to the Smart Energy Code (SEC) required to deliver the Proposed Solution.
- **Annex B** contains the full responses received to the Refinement Consultation.

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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 the current process, and to rewrite certain clauses in Plain English to mitigate the risk of misinterpretation by SEC Parties and the DCC. This modification will all SEC Parties that are subject to providing credit cover, as well as the DCC. There are no DCC costs to implement this modification. During the Refinement Consultation, respondents stated that SEC Party costs would be minimal, if any. 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. This amount is calculated by the DCC on at least a weekly basis.

Credit cover will pay for a Party's outstanding debts up to the value of the credit cover in place if they cease trading. If a Party does not have credit cover and ceases to trade, unpaid DCC charges that cannot be recovered by Administrators are socialised amongst SEC Parties, which negatively impacts the industry.

If a Party does not provide the required credit cover, it will enter an Event of Default under SEC Section M8.1. 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:

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 Bank Guarantee;
- 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 believes 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 believes 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 current processes 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'](#) (a similar modification) 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 noted 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 noted 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 bank related cover, terms could be amended. However, the DCC questions what the exchanging

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).

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 has 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 is to implement a significant redraft of the credit cover arrangements captured within SEC Section J 'Charges'. The Smart Energy Code Administrator and Secretariat (SECAS) has also rewritten 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.

The full changes to the SEC can be found in Annex A. A summary of the proposed changes to the 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, the DCC's invoices are generated monthly and so this amendment would fall in line with this process.

Value at Risk

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 annual Explicit Charges).

Parent Company Guarantees

The SEC will now explicitly state that Parent Company Guarantees cannot be used 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 has advised that obtaining a Recognised Credit Rating from Dominion Bond Rating Service (DBRS, also known as DBRS Morningstar) can be difficult, and so this modification will remove this 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 has also made changes so that only one Credit Assessment Agency is used for all SEC Parties for consistency (instead of Parties having the choice of five individual agency). The DCC will use Dun & Bradstreet as the sole Credit Assessment Agency.

Increase or Decrease in Credit Cover Requirements

This modification will amend the SEC 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 SEC 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 will send an informal reminder to a Party the month before its 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 SEC.

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. Each Party will have to review the new processes to ensure that it complies with new practices and provides the required level of credit cover. The DCC's investigation has shown that currently three Parties will need to update their 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 a minor positive impact on consumers. This is due to the potential reduction in the risk of cost socialisation, which is ultimately paid for through consumers' energy bills.

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; and
- Updating the SECAS-owned credit cover guidance document.

SEC Party costs

Refinement Consultation respondents indicated that there will be minimal costs, if any, as a result of this modification's implementation. The DCC has also advised that it has carried out analysis on current SEC Party credit cover, which has shown that three SEC Parties in total will require updating their Credit Cover Requirement. The DCC will notify these Parties, who will have one month to update their credit cover.

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 2 June 2022; or
- **3 November 2022** (November 2022 SEC Release) if a decision to approve is received after 2 June 2022 but on or before 6 October 2022.

Refinement Consultation respondents have stated that they would require one month to apply any changes to credit cover arrangements. As such, if a decision to approve this modification is received before 2 June 2022, it will be implemented as part of the June 2022 SEC Release. This will provide enough time for Parties align their credit cover arrangements with the revised SEC obligations. 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 other 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.

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 obligation of '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. The Proposer has agreed to extend this to five Working Days.

Views of the Panel

The Panel commented that it would be advantageous if the Proposed Solution is consistent with other industry Codes. This was investigated under MP095, where SECAS explored other industry Codes' credit cover arrangements. SECAS concluded that each industry Code has a different approach to Credit Cover (for example the Master Registration Agreement (MRA) and the Supply Point Administration Agreement (SPAA), which have since closed down, did not require credit cover), and therefore the current process should be amended to address inefficiencies within the current approach.

Working Group

Payment of invoices

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, which is 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.

Expiry of Letters of Credit and Bank Guarantees

The DCC discussed extending the notification to a Party whose Letter of Credit or Bank Guarantee is set to expire to 30 Working Days. The DCC advised that it should instead send an informal reminder to the Party one month prior to the expiry date. This will not require an amendment to the SEC.

SEC Party confidentiality

During the Development Stage the Panel requested that SECAS explored SEC Party confidentiality in relation to Events of Default. This was due to the Panel believing that current confidentiality provisions may cause delays in responding to Events of Default in a timely manner. Also, it was to be investigated if it would be beneficial to disclose a defaulting Party's customer numbers. 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 and after further review, as it felt that current provisions and the dataset provided to the Panel were adequate.

Implementation approach

The respondents to the Refinement Consultation agreed with the implementation approach, however sought guidance as to when a Party's new credit cover arrangements will need to be in place. Parties requested one month lead time to make the necessary changes to their credit cover arrangements, though the DCC has indicated that only three Parties will require changes immediately following implementation.

Dun & Bradstreet as the sole Credit Assessment Agency

One Refinement Consultation respondent disagreed with the DCC's suggestion of using one Credit Assessment Agency as it believed this could have a negative impact on some Suppliers (for example if they do not currently have a Dun & Bradstreet / N2 Check rating, but do have reports from other rating companies). The DCC has advised that this is to improve consistency across Parties' credit ratings. Otherwise, Parties may choose a different Credit Assessment Agency that results in less credit cover, therefore posing a greater risk of cost socialisation. The DCC added that this is only relevant to Parties that do not have a recognised credit rating. After consideration of the Refinement Consultation responses, the DCC has decided to carry forward Dun & Bradstreet as the sole Credit Assessment Agency.

Monthly Credit Assessment Reports

The respondents to the Refinement Consultation wanted clarification if there would be a cost associated with carrying out Credit Assessment Reports monthly as opposed to annually. The DCC

confirmed that it has an annual subscription with Dun & Bradstreet with unlimited use, so there will be no additional cost of changing the review frequency from annual to monthly.

Further guidance

The DCC suggested that the SECAS-owned credit cover guidance document should be updated to advise Parties of when in the month the DCC review Parties' credit cover calculation. It also suggested including flow diagrams to set out the amended process, as Refinement Consultation responses suggested that the requirements were still hard to follow. This will be carried out ahead of implementation.

Views against the General SEC Objectives

Proposer's views

The Proposed believes that this modification better facilitates SEC Objective (g)⁶ as the proposed changes will deliver efficient and transparent administration and implementation of this Code by clarifying the credit cover arrangements.

Industry views

Refinement Consultation respondents felt that this modification better facilitates SEC Objectives (b)⁷ and (d)⁸ as the added clarity will allow the DCC to comply at all times with the objectives of the DCC licence while facilitating effective competition within the energy industry. They also felt that the modification better facilitates SEC Objective (g) as it will deliver efficient and transparent administration and implementation of this Code by clarifying the credit cover arrangements.

Views against the consumer areas

Improved safety and reliability

This modification will have a neutral impact on safety and reliability.

Lower bills than would otherwise be the case

This modification will have a positive impact on the price of bills as the Proposed Solution will reduce the risk of socialised costs. Which are ultimately borne by the consumer.

Reduced environmental damage

This modification will have a neutral impact on environmental damage.

⁶ Facilitate the efficient and transparent administration and implementation of the SEC.

⁷ Enable the DCC to comply at all times with the objectives of the DCC licence and to discharge the other obligations imposed upon it by the DCC licence.

⁸ Facilitate effective competition between persons engaged in, or in commercial activities connected with, the supply of energy.

Improved quality of service

This modification will have a neutral impact on the quality of service.

Benefits for society as a whole

This modification will have a neutral impact on benefits for society.

Appendix 1: Progression timetable

Following the CSC's agreement that MP159 enters the Report Phase, SECAS will issue the Modification Report Consultation. This modification will be progressed as an Authority Determined Modification.

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 develops solution with the Proposer	Jun - Sep 2021
Modification discussed with Working Group	6 Oct 2021
SECAS and SEC Lawyer refines Proposed Solution	Oct 2021
Refinement Consultation	23 Nov – 21 Dec 2021
Modification Report approved by CSC	15 Feb 2022
Modification Report Consultation	16 Feb – 9 Mar 2022
Change Board Vote	23 Mar 2022
Authority Decision (anticipated date)	Early May 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
MRA	Master Registration Agreement
PCG	Parent Company Guarantee

Glossary	
Acronym	Full term
SEC	Smart Energy Code
SECAS	Smart Energy Code Administrator and Secretariat
SPAA	Supply Point Administration Agreement
VAT	Value Added Tax