SEC
Smart Energy Code

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Paper Reference:	**SECP_78_1303_16**
Action:	**For Decision**

DP095 progression

1. Purpose

Draft Proposal DP095 'Alignment of SEC Credit Cover' is ready to be converted to a Modification Proposal. We are recommending that this modification be progressed to the Refinement Process This paper sets out our proposed approach for progressing this modification for the Panel's approval.

The draft Modification Report setting out the detail of the modification can be found in Appendix A.

2. Summary of the issue

In the financial years 2018/2019, and 2019/20, 16 Energy Suppliers ceased trading, and it is anticipated that more will follow. This is a vast increase on previous years. This has so far resulted in unpaid Data Communications Company (DCC) charges of around £731,000 being socialised amongst all other SEC Parties. Of the Suppliers ceasing to trade, the Credit Cover circumstances have varied. The most significant example is where a SEC Party had sufficient Credit Cover for the first month's missed payment, but not for the following months. This alone resulted in around £362,000 being socialised amongst all SEC Parties. The Proposer believes that this issue needs to be resolved to minimise the current level of costs being socialised amongst Parties.

3. Proposed progression

The Change Sub-Committee (CSC) has agreed that this Draft Proposal is ready to be converted to a Modification Proposal. We believe that this modification should be progressed to the Refinement Process to allow for the development and assessment of a solution to the agreed issue.

Work package and timetable

Once the proposal enters the Refinement Process, we will work together with the Proposer to develop the business requirements and a proposed solution. We will also model the impacts of this solution to assess the impacts it is likely to have on Parties. Our strawman solution will then be discussed with industry members at the next available Working Group meeting.

Activity	Date
Agree business requirements with the Proposer and DCC	1 Apr 2020

Activity	Date
Develop solution with the Proposer	Apr 2020
Discuss at Working Group	6 May 2020
Refinement Consultation	11 May – 29 May 2020
Present Modification Report to Panel	12 Jun 2020

Areas of assessment

We do not believe there are any further questions that need to be considered in addition to the standard assessment areas.

4. Recommendations

The Panel is requested to:

- **AGREE** that DP095 should be converted to a Modification Proposal;
- **AGREE** that MP095 should be progressed to the Refinement Process; and
- **AGREE** the first package of work and the timetable as set out in this paper.

Bradley Baker

SECAS Team

6 March 2020

Attachments:

- **Appendix A:** DP095 draft Modification Report

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Smart Energy Code

DP095
‘Alignment of SEC Credit Cover’

Modification Report

Version 0.4

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.

Contents

1. Summary 3
2. Issue 4
3. Assessment of the proposal 7

Appendix 1: Progression timetable 9

Appendix 2: Glossary 10

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1. Summary

This Draft Proposal was raised by Ashley Pocock from EDF.

In the financial years 2018/2019, and 2019/20, 16 Energy Suppliers ceased trading, and it is anticipated that more will follow. This is vast increase on previous years. This has so far resulted in unpaid Data Communications Company (DCC) charges of around £731,000 being socialised amongst all other SEC Parties. Of the Suppliers ceasing to trade, the Credit Cover circumstances have varied. The most significant example is where a SEC Party had sufficient Credit Cover for the first month's missed payment, but not for the following months. This alone resulted in around £362,000 being socialised amongst all SEC Parties.

2. Issue

What are the current arrangements?

What is Credit Cover?

To mitigate the risk of costs being socialised and affecting other SEC Parties, the SEC contains Credit Cover requirements. Credit Cover is calculated and held by the DCC in the event that a SEC Party is unable to pay its monthly charge. The DCC calculates each Party's Credit Cover Requirement once a week. Credit Cover is intended to avoid unpaid charges from being socialised amongst other SEC Parties and it is important that all SEC Parties adhere to the Credit Cover requirements to minimise the impact should they enter into an Event of Default.

How is Credit Cover calculated?

Currently, the SEC Credit Cover requirements feature a complicated calculation to ascertain the level of cover a Party must have in place. A Party's Credit Cover Requirement consists of a calculation between the Party's Value at Risk and the Party's Unsecured Credit Limit. The Value at Risk is a Party's calculated level of debt, which is the value of its DCC monthly invoice plus a 40% uplift to account for payments received six weeks in arrears. The Party's Unsecured Credit Limit is its Maximum Credit Value multiplied by its Unsecured Credit Factor. These are obtained by an independent Credit Agency Assessment.

What is the issue?

Due to the parameters of the Credit Cover calculation set out in SEC Section J3 'Credit Cover', not all Parties must lodge for Credit Cover. This has resulted in high costs being socialised amongst other SEC Parties in the unfortunate event of a Default.

In the event of a default, the Panel is able to take certain actions itself, including the revocation of the following rights, as stated in SEC Section M8.5:

(a) the right of the Defaulting Party (and each other member of its Voting Group) to vote in Panel Member elections under Section C4 (Panel Elections);

(b) the right of the Defaulting Party to raise new Draft Proposals under Section D (Modifications); and

(c) the right of the Defaulting Party to influence the appointment of a Change Board Member, so that:

  (i) in the case of a Supplier Party, the Change Board Member appointed by the Voting Group of which that Supplier Party forms part shall be suspended; or

  (ii) in the case of any Party other than a Supplier Party, the Secretariat shall ignore the views of that Party when considering any request to appoint or remove a Change Board Member appointed by the Party Category of which that Party forms part.

Further actions require approval of the Authority (Ofgem). It has been noted that the process of gaining approval can be drawn out, and it has been suggested that an expedited process may reduce the risk of costs being socialised. Withdrawing certain rights from a defaulting Party should, in theory,

provide incentive for them to take action in resolving the Event of Default in order to reinstate their rights as quickly as possible.

SEC Section M8.6 states that in the event of a default, the Panel must request authorisation from the Authority to withdraw:

(a) the right of the Defaulting Party to receive Core Communication Services or Local Command Services in the 'Other User' User Role;

(b) the right of the Defaulting Party to receive Core Communication Services or Local Command Services in any User Role other than the 'Other User' User Role;

(c) the right of the Defaulting Party to receive any or all Elective Communication Services;

(d) the right of the Defaulting Party to initiate Enrolment of Smart Metering Systems; and

(e) the right of the Defaulting Party to request or receive any or all Services other than those referred to elsewhere in this Section M8.6.

Under these circumstances, the Smart Energy Code Administrator and Secretariat (SECAS) will aim to build a case to suggest that the Authority should approve the Panel's decision to suspend these rights.

However, to date the current arrangements have not prevented the costs of defaulting Parties from been socialised.

The Proposer therefore wishes to explore the current Credit Cover requirements to identify if there are ways it can be amended to reduce the risk of cost socialisation across the industry.

As part of this modification, other aspects surrounding the Defaults process will also be explored, such as actions which the SEC Panel can take when a Default occurs or is anticipated, and the actions of and escalations to the Authority.

In order to gain Ofgem's approval as quickly and as efficiently as possible during an Event of Default, the Proposer and SECAS also propose to explore options in conjunction with the other energy industry Codes. A potential collaboration with an existing Code could accelerate an approval, as the Event of Default could prove more urgent.

Previous modifications addressing the subject of Credit Cover

Previously implemented modifications were researched to provide background for this proposal. The Operations Group considers that MP076 'Pursuing Non-Payment in Events of Default' (implemented 29 November 2019) should be reviewed to gain a greater understanding of issues involving Events of Default. Furthermore, the Proposer recommended that SECMP0016 'Consideration of Maximum Credit Value in Credit Cover Calculation' (implemented 1 April 2017) is also reviewed.

MP076 addresses an issue identified in SEC Section J2.6 'Pursuing Non-Payment' where the DCC are obliged to keep the SEC Panel updated on matters regarding pursuing non-payment as well as allowing the Panel to express their views.

Before implementation, the SEC stated that ultimately the DCC must decide what it considers to be the best course of action (unless the Panel say it is no longer worthwhile to try and recover the costs). The solution required amendments to Section J2.6(b) by placing obligation on the DCC to take all reasonable steps to gain agreement from the Panel for its approach to pursuing non-payment, as well

as simply consulting with the Panel as under the original arrangements. This approach provides better clarity for the DCC and the Panel in how to manage Events of Default in the future.

SECMP0016 was raised to make changes to the SEC Credit Cover Requirement calculation so that the credit value specified by an independent credit assessor is taken into account. This was due to the Proposer identifying that the DCC held approximately 72% of the Value at Risk (VAR) in Credit Support. The Credit Support is working capital that could be otherwise invested elsewhere in a Party's business. It was also felt that the high amount of Credit Support would act as a barrier for new market entrants and prevent growth. The solution brought this figure down to 30%.

The SECMP0016 Modification Report states that as a result of the solution, compliant Parties would be exposed to increased socialised Unrecovered Bad Debt Payments if an Event of Default were to occur. The reoccurring Events of Default over the past two financial years have proved this a reality.

What is the impact this is having?

If a Party ceases to trade and they do not have sufficient Credit Cover, or it was not deemed necessary for it to lodge Credit Cover, all costs are socialised amongst SEC Parties. This has occurred twice in the financial year 2019/20 and is creating frustration amongst SEC Parties that a more effective system has not yet been implemented.

If left as is, there could be many more examples in the future where Parties ceasing to trade or behaving in a manner which leads to default result in having their unpaid charges socialised.

3. Assessment of the proposal

Observations on the issue

Comments were received from Change Sub-Committee (CSC) members when taken for initial discussion, that this is an area of concern and they recommended that the issue is investigated further in the Development Stage before progressing.

This proposal has also been presented to each Panel Sub-Committee for initial comment. The Sub-Committees have expressed their concern for the frequency of Events of Default and also the associated socialised costs.

Initial comments were received from a Large Supplier who shared the Proposer's concern. It felt that the current Credit Cover management is ineffective, as evidenced by the level of socialised costs. It supported the proposal as it believed that it is unacceptable that the situation continues.

Discussions have been held with other industry Codes with a view to potentially aligning both our approaches, however the exchange of a Party's sensitive information between Codes could be seen as a breach of GDPR.

The proposal was subsequently taken to back CSC for decision, where members were happy with the development undergone, and recommended that the proposal is converted into a Modification Proposal and enters the Refinement Process.

What is the magnitude of the issue?

To gain a greater understanding of the issue identified, SECAS discussed in detail the subject of Credit Cover with the DCC. The DCC raised concern regarding the number of Suppliers entering Events of Default. They highlighted the number of Suppliers ceasing to trade since 2016 and SECMP0016's implementation. The DCC cited the change in the industry's landscape in recent years as a contributing factor.

Further to the discussion, the DCC provided a breakdown of two examples of Events of Default that resulted in debt socialisation. This gave a clear comparison between the level of debt socialisation pre and post SECMP0016's implementation.

Socialised Costs		
	Supplier 1	**Supplier 2**
Value at Risk	£317,951	£299,296
D&B Rating	2A1	2A1
Maximum Credit Value	£4,252,500	£2,835,000
Unsecured Credit Factor	8.5%	8.5%
Unsecured Credit Limit	£361,463	£240,975
Credit Cover Factor	80%	80%
Credit Cover Required		
Pre SECMP0016	£254,361	£239,437
Post SECMP0016	£0	£58,321

Socialised Costs		
	Supplier 1	**Supplier 2**
Socialisation Exposure		
Pre SECMP0016	£63,590	£59,859
Post SECMP0016	£317,951	£240,975
Actual Credit Cover Held	£0	£215,939
Actual Socialisation	£317,951	£83,357
Potential Reduced Socialised Debt	**£254,361**	**£23,498**

As the table above shows, the level of socialised debt has increased substantially since the implementation of SECMP0016. This was stated as a risk in the final version of the SECMP0016 Modification Report.

Appendix 1: Progression timetable

Once the Panel converts this to a Modification Proposal SECAS will work with the Proposer to develop a strawman solution which will be discussed at a Working Group meeting.

Timetable	
Action	**Date**
Present to CSC for decision to convert to Modification Proposal	25 Feb 2020
Panel convert Draft Proposal to Modification Proposal	13 Mar 2020
Agree business requirements with the Proposer	1 Apr 2020
Develop solution with the Proposer	Apr 2020
Discuss at Working Group	6 May 2020
Refinement Consultation	11 May – 29 May 2020
Update Panel on progress	12 Jun 2020

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
SEC	Smart Energy Code
SECAS	Smart Energy Code Administrator and Secretariat
VAR	Value at Risk