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6th September 2005

Mod 0041

Dear Julian,

Thank you for inviting us to respond to Mod Proposal 0041. Although there are similarities between Mod 0023, 0031 &0041 there are important differences both in the content of the proposals and in the drafting of the Draft Mod Reports. I will comment on the drafting of Mod 0041 first and later in this letter upon the aspects of the proposal itself.

In the DMR of Mod Proposal 0031 section 2 "Extent to which implementation of the proposed modification would better facilitate the relevant objectives" there is a paragraph which records the fact that some but not all transporters "expressed a view that increasing the availability of unsecured credit could increase costs in the event of default, thereby increasing costs for other Users, and hence does not facilitate the securing of effective competition between Relevant Shippers since this would deter entry". It is interesting to note that this paragraph is not included in the Draft Mod Report for Proposal 0041 although this proposes to include the same bands of credit ratings as Proposal 0031.

As to the content of the proposal, there are two parts; the first part looks to set the maximum unsecured credit limit at 2% of the Transporters Regulatory Asset Value. The second part deals with the level of unsecured credit that is allowed by the Transporter according to the credit rating agencies Standards & Poor's and Moody's Investors Service.

The arguments surrounding the introduction of the maximum unsecured credit limit of 2% of the Transporters Regulatory Asset Value are identified in the Best Practice Guidelines. We agree with this aspect of the proposal.

This proposal supports the principal of introducing all three BB credit ratings into the UNC but disagrees with the amount of unsecured credit that the company should enjoy. We believe that there has been a misunderstanding as to the purpose of a Credit Rating. The proposer presents some interesting statistics, which at first sight might give cause for concern; after further consideration of the history of credit default the picture is not so grim. Companies are awarded a credit rating at the start of the 5 year period of the debt, and unless a company experiences a sudden and catastrophic collapse such as Enron, there will be opportunities for downgrading of a company's credit rating during the period. Credit rating agencies are generally quick to take such action as it protects their reputation as well as preventing litigation. What these statistics do not show is how many of the BB rated companies that defaulted did not have their debt down graded. This would be a better indication of the risk.

Nevertheless, a transporter is not exposed to a 5 year risk, but to a maximum of 2 months. There are processes in place to effectively terminate a Shipper if invoices are not paid by the end of the second month.

JP Morgan the highly regarded bank has developed a method of assessing payment risk, known as CreditMetrics TM. This well established and relatively simple method facilitates an analysis of the risk of default on short term debt (90days).

	45 days	90 days
AAA	0.00%	0.00%
AA	0.00%	0.00%
A	0.00%	0.01%
BBB	0.04%	0.08%
BB	0.13%	0.28%
B	0.72%	1.46%
CCC	5.23%	9.99%

The above table clearly shows that the likelihood of a BB rated company defaulting on its short term debt is not materially different to that of an AAA rated company.

Transporters have suggested in the Distribution Workstream meetings and it is noted in the Draft Mod Report that they might incur additional costs in monitoring a BB or below rated company. It seems unlikely that they would not have been monitoring any such companies previously. There was also the suggestion that there would be a one off development cost in establishing a process. Users requested that Transporters provide evidence of the potential costs but to date we have not had sight of these so we are not able to comment further. Nevertheless we would expect the Regulator to subject these costs to care scrutiny.

We do not support this proposal, but believe that Mod 0031, which seeks to introduce the credit ratings and bands of unsecured credit as identified in the Best Practice Guidelines is the better option

Yours sincerely,

Simon Howe.

Gas Network Codes Manager