

## **Centrica's completed acquisition of Dynegy Storage Limited and Dynegy Onshore Processing UK Limited**

### **Summary of Ofgem's views on the transaction**

#### **Introduction**

On 14 November 2002, Centrica announced the completed purchase of Dynegy Storage Limited and Dynegy Onshore Processing UK Limited. The purchase was examined by the Office of Fair Trading (OFT) under the Fair Trading Act 1973, to determine whether the transaction would operate against the public interest. In assessing mergers in the gas and electricity sectors, the OFT seeks the advice of Ofgem. Ofgem's advice was provided to the OFT following a consultation document published in December 2002<sup>1</sup>. The OFT then made a recommendation to the Secretary of State for Trade and Industry (SoS) that the merger could not be approved with undertakings and therefore that it should be referred to the Competition Commission. The transaction was referred to the Competition Commission on 25 February 2003.

Ofgem's advice to the OFT was the result of an investigation into the effect of the merger, drawing in part on the replies to the December 2002 consultation document. Since this particular merger has resulted in a Competition Commission reference, Ofgem has decided to publish a summary of its current view of the transaction (on the basis of which it advised the OFT). Ofgem anticipates that it will make submissions to the Competition Commission during the reference period and will develop these views further as the inquiry progresses.

#### **Consultation exercise**

There were 21 responses to Ofgem's consultation (four of which were confidential). Of the responses, six believed that a Competition Commission reference was necessary. 15 considered that a reference could be avoided with effective undertakings. The main points raised in the consultation were as follows:

- No respondents thought that the transaction should proceed without undertakings;

- Most agreed that, absent undertakings, the transaction represented a substantial lessening of competition, in particular in the retail energy markets;
- Some thought that the acquisition of Rough would give Centrica significant horizontal market power in storage and that Centrica already possessed vertical market power through its dominant position in domestic gas supply and position in industrial and commercial gas and electricity supply; and
- Some respondents believed that the formal undertakings entered into by Dynegy should be applied to Centrica in full, but that there were strong arguments that they should be reviewed, strengthened and extended in the following areas -
  - Capacity availability
  - Business separation
  - Transparency of information
  - Access to Centrica's long term interruptible contracts
  - Extension of undertakings beyond 2004
  - Direct licensing of Rough
  - Divestment of Rough and / or Morecambe

### **Ofgem's analysis**

Ofgem analysed the effect of the merger by examining the substitutes for Rough, the way in which those substitutes could constrain an operator of Rough and the extent to which Centrica's purchase of Rough affected those constraints.

#### *Substitutes for Rough*

There are several ways in which Rough provides services to the gas market. Ofgem's analysis concluded that the two most important of these are:

- as a source of winter gas (reflecting the much higher demand for gas in winter than summer); and
- in providing daily (including within day) flexibility.

In the time available, Ofgem did not consider the effect of the Centrica purchase with respect to other issues, such as summer gas or the operation of the Easington terminal.

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<sup>1</sup> "Centrica's completed acquisition of Dynegy Storage Limited and Dynegy Onshore Processing UK Limited, A consultation document", Ofgem, December 2002

Ofgem analysed the response of the various potential substitutes to Rough to changes in demand / price during the winter ("winter gas") and to changes in demand / price on a daily and within day basis ("daily flexibility"). We concluded that the extent to which other facilities are relatively close substitutes for Rough is different for these two uses.

In the market for winter gas, the conclusion of Ofgem's analysis was that:

- the Morecambe gas fields and other beach supplies are reasonably close substitutes for Rough;
- the interconnector is also a reasonably close substitute; and
- interruptible supply contracts are likely only to act as a constraining factor on Rough in cold winters.

In the market for daily flexibility, the conclusion of Ofgem's analysis was that:

- the Morecambe gas fields are a relatively close substitute for Rough;
- the interruptible supply contracts are relatively close substitutes;
- Hornsea is a good substitute; and
- the interconnector is a reasonably close substitute.

#### **Centrica's position with respect to these substitutes**

Centrica has significant positions in these substitutes for winter gas and daily flexibility, in particular the Morecambe gas fields and interruptible contracts. Ofgem's analysis examined the extent to which Centrica's position with respect to substitutes for Rough was augmented by the purchase of Rough. In all cases, Centrica's overall position in the markets for winter gas and daily flexibility increased. In some cases, the effect of the transaction on market share was reasonably limited. In other cases, the effect of the transaction was very significant. Looking forward, Ofgem concluded that Centrica's position in these markets could be reasonably expected to remain for the next six to seven years.

#### **Possible competition detriments**

Absent undertakings, Ofgem concluded that the analysis showed that the transaction could be expected to lead to the following detriments:

- the incentive and ability to restrict capacity to increase wholesale gas prices;

- this arises in particular from the combined ownership of Rough and the Morecambe gas fields
- the possible incentive and ability to restrict capacity to reduce competition in downstream supply markets;
  - this is of particular concern given Centrica's strong market position in the domestic gas market and the fact that all suppliers need access to flexible gas supplies
- reduced incentives to innovate or invest at Rough;
- access to commercially-valuable confidential information; and
- reduced liquidity in the traded market.

### **Addressing the detriments**

Ofgem's view is that, absent undertakings, these detriments represent a substantial lessening of competition. We considered possible remedies and our view is that the following undertakings would be able substantially to address the identified detriments:

- 15% of capacity at Rough reserved to Centrica, with Centrica forbidden from participating in the primary sale of remaining Rough capacity;
  - this level chosen to be somewhat less than might be required by Centrica, thereby incentivising Centrica to develop further capacity at Rough, and to facilitate secondary trading
- 65% of capacity at Rough offered on long term contracts commencing storage year 2004/5, contract length to be a weighted average of 5 years;
  - the offering of long term contracts to third parties was intended to address the combined ownership of Rough with other Centrica owned substitutes
- 20% of capacity at Rough offered on annual contracts;
  - to ensure new entrants had access to Rough
- sale of capacity on non discriminatory terms, with the method of sale decided by Centrica, although no contracts to be entered into that included indexation to any UK or European gas prices;
  - contracts linked to indexation would not address Centrica's incentives with respect to wholesale prices
- use it or lose it to apply to all capacity at Rough;
  - this ensures that, in the end, all capacity comes to market

- incremental expansion at Rough free from the undertakings regarding the sale of capacity;
  - this incentivises Centrica to examine the possibility of expanding the capacity of Rough
- separation of Centrica Storage, and possibly Morecambe, from the rest of Centrica
  - this prevents confidential information flowing from Rough to the rest of Centrica; and
- undertakings to last six years
  - this being the time that Centrica's position with respect to substitutes for Rough can be expected to last.

In developing these undertakings, Ofgem considered that there could be tradeoffs between certain of the relevant parameters, in particular between long term capacity rights from Rough and other sources of flexibility from Centrica's portfolio such as the Morecambe gas fields.

### **Conclusion**

Our current view is that this sale has the potential to lead to higher prices for gas customers because it gives Centrica the power to withhold capacity from the market in order to force up gas prices. Without undertakings to limit Centrica's use of Rough, and to allow other firms access to the facility, competition will be undermined. Ofgem intends making an initial submission to the Competition Commission based on the above analysis and conclusions, including further analysis as required.