

# **Centrica / Dynegy merger inquiry: Issues statement**

## **Ofgem response 27/03**

### **Introduction**

Ofgem submitted a detailed report on its views on the transaction involving Centrica's acquisition of Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd to the Office of Fair Trading in January 2003. This report was sent to the Competition Commission in February 2003. That report addresses many of the issues raised in the Commission's Issues Statement. A summary of the report is available on Ofgem's website<sup>1</sup>. The whole report, with a few deletions made for reasons of confidentiality, was provided by the Competition Commission to Centrica in April 2003.

### **Market definition**

Ofgem's view of the market definition relevant to this particular transaction, and the analysis supporting this view, is contained in Ofgem's report on this transaction. We therefore agree that two relevant markets with respect to this transaction are winter gas and daily flexibility. Due to the timescales of the investigation, we did not investigate summer gas, or the control of the Easington terminal. We do not consider that Transco's LNG facilities act, or would act, as a substitute for Rough within the markets investigated.

### **Centrica's position**

Ofgem analysed Centrica's position in its report on the transaction. We demonstrated that Centrica had wider (i.e. in terms of the Morecambe gas fields and the LTI contracts) and deeper (i.e. in terms of its significant supply portfolio) interest than Dynegy. Thus, as the Competition Commission identifies, the transaction adds substantially to Centrica's position in the supply of flexible gas. Hence, the regulatory remedies (i.e. undertakings in lieu of a Competition Commission reference) needed to be wider and deeper than those put in place for Dynegy.

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<sup>1</sup> "Centrica's completed acquisition of Dynegy Storage Limited and Dynegy Onshore Processing UK Ltd, Summary of Ofgem's views on the transaction" Ofgem, February 2003

One aspect of Centrica's position that is not explicitly referred to by the Competition Commission and that we believe the Competition Commission may wish to consider further is Centrica's wholesale electricity position. We note that Centrica supplies gas to a significant proportion of the gas fired power stations (in particular via the LTIs), owns power stations (with its latest purchase, Roosecote, a power station also supplied under an LTI, announced in April 2003) and purchases electricity from power stations. In addition, Centrica has a significant wholesale electricity trading position, which includes Accord Energy, a wholly owned Centrica subsidiary. It is possible that, as a result of the Rough transaction, Centrica's increased market power in wholesale gas could have negative impacts on competition in the wholesale electricity market. We consider that the Competition Commission could usefully explore this issue.

### **The counterfactual**

In order to assess the effects of the merger, the Commission has requested views on what would have been likely to happen in the absence of the merger (the counterfactual). As the Commission notes, although it is not possible to reach a firm view on who would have bought the Rough facility if it had been acquired by an owner other than Centrica, parties other than Centrica were interested in acquiring the facility from Dynegy. In particular, Ofgem had discussions with another party with no other significant interests in the GB gas or electricity markets. Ofgem had no reason to consider that this party was not a credible alternative purchaser of the Rough facility. We would therefore consider this party to represent an appropriate counterfactual when assessing the Centrica merger.

Although it is not possible to specify the exact advice that Ofgem would have provided to the OFT in assessing such a merger, the fact that the potential buyer had no prior position in the GB gas and electricity markets could have put it in a similar, if not more favourable (in competition terms), position to Dynegy which also had significant trading interests. In that case, we would not therefore have expected undertakings that were more onerous than those that were placed on Dynegy.

The alternative purchaser and Centrica can be characterised as being at polar ends of a spectrum of potential purchasers of Rough, with the alternative purchaser representing a party with no other interests in the GB gas and electricity markets and with Centrica

representing a party with very significant interests in both. Within such a spectrum there could be a number of alternative purchasers which could be characterised thus:

- upstream gas producers;
- integrated players with interests in downstream gas and electricity markets;
- overseas physical energy companies with no UK interests; and
- financial buyers.

Without further consideration of the specific issues arising under any acquisition, it is not possible to determine what, if any, remedies would be required in the event that a purchaser of Rough came from any one of these particular groups: each case would have to be assessed on its merits. Clearly, there are some parties where undertakings could be more onerous than Dynegey, but less so than those proposed for Centrica. However, Ofgem agrees with the Competition Commission that it is likely that the acquisition of Rough by any other buyer(s) would have been less problematic for competition than the proposed Centrica transaction.

### **Public interest issues**

The 12 public interest issues identified by the Competition Commission are mostly identified in Ofgem's report on the transaction and our detailed comments are contained within that report. Ofgem's summarised views on the public interest issues are -

- (i) *[ Competition Commission text ] whether , as a result of the merger, Centrica has the incentive and ability to withhold Rough capacity and/or other source of flexibility from buyers of flexible gas, with the effects e.g. of increasing prices of flexibility and reducing liquidity in gas trading.*

[ Ofgem answer] Yes. We believe that Centrica has the incentive and ability to withhold Rough capacity and / or other sources of flexibility and / or fail to invest in expanding capacity. We note the argument by Centrica that it is exposed to any wholesale gas price increase in the same way as other suppliers. We do not consider this to be the case due in part to the

existence of the LTIs which can be seen as a long term shield from exposure to wholesale gas prices.

- (ii) *whether Centrica has the incentive and ability to discriminate between customers in the terms on which it makes Rough capacity available.*

Yes. In the absence of undertakings, we consider that Centrica does have the incentive and ability to discriminate between storage customers.

- (iii) *the effects of (i) and (ii) above on wholesale gas prices (effects may include increasing average winter prices, increasing price spikes at times of particularly high demand, and reducing summer prices);*

Ofgem considers that Centrica does have the incentive to restrict capacity to increase wholesale gas prices. This results in particular from the combined ownership of Rough and the Morecambe gas fields.

- (iv) *whether Centrica's access to operational and customer information concerning Rough give it an unfair advantage in the market(s) for flexible gas and in downstream markets;*

Yes. We consider that the separation proposals already made by Centrica would prevent, to a large extent, Centrica obtaining commercial advantage from its access to Rough information. However, the proposed separation arrangements do not prevent information flowing between Rough and Morecambe, and hence to other parts of Centrica's business.

- (v) *whether, as a consequence of Centrica's ownership of Rough in addition to its control of other sources of flexibility, there is – or could be – insufficient information available to other companies to enable them to operate efficiently within downstream markets;*

The issue of information availability on Centrica's other sources of flexibility was not explored in Ofgem's report.

- (vi) *whether Centrica would lack the incentive to innovate in the management of Rough, e.g. in the range of products and type of contracts offered to customers;*

Yes. In this context, we also note that the undertakings themselves (e.g. by allowing a storage services contract to be changed only by agreement by OFT) could in themselves stifle innovation.

- (vii) *whether Centrica would lack the incentive to invest in increasing capacity at Rough, whether in injection or delivery rates or in amount of storage space;*

Yes. Again, this arises in particular from Centrica's combined ownership of Rough and the Morecambe gas fields. Any increase in capacity at Rough could, other things being equal, affect the valuation of Morecambe. This would seem to affect Centrica's incentives to invest in increasing capacity at Rough.

- (viii) *whether the merger would increase the risks and uncertainty faced by Centrica's competitors, and by potential entrants, in gas storage and downstream markets;*

Yes. To be active in the retail supply market, suppliers need access to flexible gas supplies. This requirement for access is particularly important with respect to supply to domestic customers. Any withholding of capacity in the market for winter gas or daily flexibility, and the associated increase in price, could therefore be expected to have adverse effects on entry or expansion opportunities in the market for retail supply. In short, the price effects would raise the costs of competitors to Centrica in retail gas supply. It is important to note that, in the absence of any conduct along these lines,

a perception in the market that Centrica could act to limit access to the necessary flexible gas supplies might, of itself, be expected to deter entry or expansion.

- (ix) *whether competition, or lack of it, in downstream markets is such that Centrica would be able to pass on to customers any increases in the wholesale price of gas;*

Yes. We can see that Centrica's 5.3% gas price rise in January 2002 only had a short term impact on sales and retention of customers, typically because competing suppliers raised their own prices shortly thereafter.

- (x) *whether, alternatively or additionally, Centrica would be able to put a margin squeeze on its less vertically integrated competitors, particularly in the retail supply of gas to domestic customers, and whether any such squeeze would also restrict entry into downstream markets;*

Yes, alternatively and additionally.

- (xi) *whether any competition issues arise as a result of Centrica's acquisition of the Easington terminal;*

Ofgem has not investigated any competition issues arising from Centrica's acquisition of the Easington terminal due to the timescales associated with this investigation. It is an issue that could be usefully explored by the Competition Commission.

- (xii) *whether any of the possible adverse effects listed above would be exacerbated by developments such as those outlined in paragraph 5 above.*

Ofgem does not consider, on the basis of today's expectations, that Centrica's market power is likely to be strengthened at the end of, say six to

seven years (this being the period when the LTIs begin to decline).

However, it is possible that Centrica's market power could increase over the next year or two.

The Competition Commission, to set against these 12 public interest issues, has identified two possible benefits. We note that neither of the benefits refers to a benefit to competition resulting from the transaction. (In addition, we note that Centrica's own views<sup>2</sup> on the transaction also do not refer to a benefit to competition arising from the transaction.)

Nevertheless, Ofgem's comments on these possible benefits are as follows –

- *observation of high standards in the operation and maintenance of Rough*

Ofgem is not aware that Centrica is any better or worse than any other offshore operator in this respect.

- *confidence among users resulting from Rough being in the hands of a financially strong company which is expected to be a long-term player in GB energy markets*

Clearly, if users were not confident of using the Rough facility due to the financial standing of the owner, this could have a detrimental effect on competition. However, Ofgem does not consider that Centrica is the only party that fulfills this criterion. Further, we note that the financial remedy put in place by Dynegy to address the "title to gas" issue, has, we understand, been retained by Centrica.

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<sup>2</sup> "Acquisition by Centrica plc of Dynegy Storage Limited, Dynegy Onshore Processing UK Limited, Summary of Centrica's submission to the Competition Commission", Competition Commission, March 2003

## Hypothetical remedies

Ofgem's views as to remedies that would substantially address the detriment to competition associated with the Centrica transaction were included in our report on the transaction.

Ofgem's proposed remedies are largely contained in the hypothetical remedies listed below. Our views as to whether the individual remedies identified by the Competition Commission could be contained in a package of undertakings is given as follows -

*[Competition Commission text] Could any adverse effects be remedied fully by Centrica giving some or all of the following undertakings -*

- a) *Rough's full capacity would be made available to users*

[Ofgem answer] Yes.

- b) *"use it or lose it" provisions would continue to apply to Rough capacity in order to ensure that capacity was used and not hoarded;*

Yes.

- c) *Capacity would be sold through auctions with no reserve price, in order to ensure that there was no discrimination between customers or manipulation of the price by Centrica;*

In its submission to the OFT, Ofgem argued that all capacity should be offered, and sold, by way of auctions. We note that the Competition Commission is asking for views on no reserve price in such auctions. Ofgem's view is that any reserve price should be set no higher than the avoidable costs associated with use of the Rough facility. In our OFT report, we noted however that setting such a reserve price would not be straightforward.

- d) *Prices would not be indexed to wholesale gas prices, or to the differential between summer and winter prices, in order to avoid giving Centrica an incentive to force up the index;*



Ofgem does not consider that allowing Centrica to sell Rough capacity on terms related to gas prices addresses the detriment resulting from Centrica's incentive and ability to manipulate wholesale gas prices. We also note that Centrica has claimed that part of the rationale for purchasing Rough is to hedge against Centrica's exposure to the volatility in the price of gas flexibility. Indexation would explicitly result in exposure to movements in the relevant index remaining with Centrica.

- e) *A specified minimum proportion of capacity should be offered on long-term contracts (say up to five years), and a specified minimum to be offered on annual contracts;*

Ofgem considers that a significant proportion of capacity should be made available on long term contracts since putting long term rights into the hands of third parties substantially addresses the incentive to withhold capacity from the market. The choice as to duration is a balanced one, although we consider that five years would be the minimum duration that would provide a suitable remedy to this concern given the period over which Centrica's increased market power remains significant. We also consider that a proportion of capacity (around 20%) should be available on annual contracts to help address the detriment to supply competition.

- f) *Centrica would not bid in the primary auctions for the sale of existing Rough capacity (since it would have no incentive to bid low) but would reserve a specified maximum share of capacity for itself at the average prices emerging from the auctions for contracts of the relevant period, and buy any additional capacity it wanted in the secondary market; your views are invited on what the specified maximum reservable for Centrica should be, and whether it might be set below Centrica's expected requirement in order (1) to oblige it to buy some of its requirements in the secondary market and (2) to give it an incentive to develop additional capacity;*

In its report to the OFT, Ofgem recognised this to be difficult issue. There are arguments for and against a capacity reservation, and resulting implications as to whether Centrica would or would not be allowed to participate in a primary auction (or other form of allocation). We concluded that Centrica should be allowed to reserve a proportion of Rough capacity for itself, but should not be allowed to participate in any primary auction (or other form of allocation). As to the level of capacity reservation, Ofgem suggested 15%. As explained in Ofgem's report, this was deliberately set lower than Centrica's current requirements. We concluded however that there did not need to be a cap on Centrica's total bookings (i.e. Centrica was not to be restricted in its activities in the secondary market).

- g) *Centrica would facilitate the efficient operation and development of a secondary market in Rough capacity;*

Yes.

- h) *Centrica would maintain a strict legal, financial and physical separation between its storage operations and all other parts of its business, and ensure that no privileged information passed from the storage operations and all other parts of its business, and ensure that no privileged information passed from the storage operation to other parts of the group;*

Separation, including legal, financial and physical separation between storage and all other parts of Centrica (including the Morecambe operations) is vitally important. In this respect, we note that Centrica has already moved the storage business into a Centrica building.

- i) *Relevant information, e.g. on the aggregate daily utilization of Rough capacity, would be published in order to give all users and other interested parties equal access and help create confidence in the operation of this important part of the wholesale gas market and in the effectiveness of the undertakings given by Centrica?*

Ofgem did not focus on this particular remedy. However, information publication could be a useful way of giving users confidence in Centrica's usage of Rough and, if appropriate, other sources of Centrica flexibility.

#### *Undertakings with respect to other sources of Centrica's flexibility*

The Competition Commission asks whether undertakings could be given with respect to Centrica's operation of the Morecambe gas fields, the LTIs or its other sources of flexibility. In its report on the transaction, Ofgem indicated that there could be trade-offs between the undertakings suggested for Rough, and Centrica's other sources of flexibility. However, we noted that the definition of capacity availability with respect to Centrica's other sources of flexible gas would not be straightforward, and would amount to an extension of regulation into currently unregulated activities.

An example of the difficulty of extending regulation to other sources of Centrica flexibility can be seen from the differing forecasts, over time, of Morecambe deliverability. When assessing the potential importance of flows from the Morecambe fields over time, it is important to recognise that peak capability of the Morecambe fields is, at least to some extent, a variable that for Centrica as owner is controllable. Ofgem's records of past forecasts of Morecambe peak capability levels (provided as part of past supply price control assessments) indicate that forecast peak levels and the forecast speed of decline have changed over time, and in some cases very significantly. These points highlight the difficulty of coming to a clear regulatory view on the peak capabilities of Morecambe over time, and strongly indicate that the level of these capabilities should be understood as a control variable for Centrica, at least to a material extent.

#### *Duration of undertakings*

The Competition Commission asks what period any undertakings should apply for. Ofgem suggested six years, this being the period over which Centrica maintained a significant level of market power. However, this was a balanced decision, and it is possible that longer (though not shorter) undertakings would also be appropriate. The period of undertakings was in part dependent on the information provided as to the projected decline in the Morecambe gas fields.

### *Impact of undertakings*

The Competition Commission asks whether the undertakings constitute “excessive regulation, creating distortions and preventing the market in flexible gas from evolving in response to market signals”. Ofgem does not consider that this is necessarily the case. However, we recognise that the nature of the proposed undertakings represented increased storage regulation, as opposed to the reduced storage regulation that could have resulted from an alternative purchaser.

The Competition Commission asks if some or all of the hypothetical undertakings outlined above would “address fully the possible adverse effects”. As outlined to the OFT, a package of undertakings could, in principle, substantially address the detriments to competition. It is possible that an alternative package of undertakings could “fully address the possible adverse effects”. However, Ofgem has not yet come to a view on this point.

### *Structural remedies*

As was set out in our advice to the OFT, Ofgem considers that while the issues raised by the transaction are significant, these issues could be substantially addressed without the need for a full structural remedy (i.e. divestment). Having said that, the undertakings that we proposed were significant. Ofgem’s proposed undertakings – and in particular the requirement for a specified amount of capacity to be sold on a long term basis - can be understood as seeking to provide for a form of semi-structural remedy. That is, whilst Centrica would be allowed to retain full ownership of the facility, the undertakings seek to substantially reduce Centrica’s financial interest in, and effective control of, Rough for a defined period.

In reaching our view that divestment was not necessary, we aspired to balance the fact that competition is superior to regulation against the wish not to stand in the way of appropriate industry restructuring. However, this was a finely balanced judgment, and recognised that account needed to be taken of the potentially detrimental effects that the resulting level of regulation might have on competition (for example, in terms of limits it may place on innovation).

If the Competition Commission were to consider divestment a necessary remedy, then the specific approach taken to divestment could have a significant impact on the extent to which the resulting structural change could in practice be expected to address the identified sources of competitive detriment.

Clearly the divestment of the whole of Rough, including the Easington terminal, would directly address the impact of the transaction by putting Centrica's position back to that of the pre-merger state. There may be a number of detailed issues for example concerning the timescale over which such full divestment would be required to take place, and what restrictions – if any – should be placed on the form of sale (for example, in terms of the extent to which additional features such as capacity rights bookings could be incorporated into the sale process).

A structural remedy that involved the divestment of other sources of flexibility available to Centrica would be more difficult to assess. Given that alternative sources of supply and demand responsiveness can be understood as substitutes to varying degrees, it is to be expected that issues raised by the transaction could be addressed at least in part through remedies that focus on these other sources of flexibility. Ofgem explicitly recognised this in our proposed undertakings by explicitly indicating that some trade-offs could be made between the provision of Rough capacity and the provision of capacity at Morecambe. A key difficulty in assessing such trade-offs would be determining what appropriate 'exchange rates' should apply to divestment of alternative sources of flexibility. Nevertheless, specific options could be worthy of consideration.

Divestment of part of Rough, so that it was operated as a joint venture, potentially raises a number of problematic issues. The central issues concern the extent to which any particular form of partial divestment addresses concerns that have resulted from the transaction in relation to Centrica's ability and incentive to raise relevant prices. If partial divestment meant that Centrica continued to exercise control or material influence over the management and / or operation of Rough, then it would seem to have limited effect in addressing concerns regarding Centrica's ability to raise relevant prices. More generally, the position of Centrica as part owner may give rise to concerns regarding the commercial terms by which it gains access to Rough services. The size of Centrica's financial stake

would also be of significant importance in terms of the resulting effect on Centrica's incentives to seek to raise relevant prices.

In summary, given that Ofgem's decision to recommend undertakings to the OFT was a finely balanced one, Ofgem would support the Competition Commission exploring structural remedies as an alternative way to address the issues arising from the Centrica transaction.

Office of Gas and Electricity Markets

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