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Rochelle Ladd
Managing Director, Competition and Trading Arrangements
Office of Gas and Electricity Markets
9 Millbank
London
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Centrica's completed acquisition of Dynegy Storage Ltd and Dynegy Onshore Processing UK Limited

Dear Rochelle,

LE Group welcomes the opportunity to comment on Centrica's completed acquisition of Dynegy Storage Ltd and Dynegy Onshore Processing UK Limited.

We especially welcome the consultation document, as it succinctly summarises the key issues. We agree with its analysis and with the conclusion that the transaction is expected to lead to a substantial lessening of competition (SLC).

On this basis, we would like to see Rough Storage become completely separated from the rest of the Centrica Group. It should operate at arms length from the rest of Centrica's other business activities, undertaking its own auctions and bilaterals; no information about its activities should flow back into Centrica without publication at the same time to the market as a whole. These restraints would stay in place until the market for swing capability became very much more competitive. This may well require Rough to operate under a licence. If this regime is not considered acceptable, we see no alternative but to refer the acquisition to the Competition Commission.

Our own estimate of the markets which involve swing, and Centrica's (CNA) share of each after this transaction, are given in the table below:

Table 1

Swing/day MCM	Total daily Market (MCM)	CNA Vol.	CNA %
Beach flow	38	3.8	10
Storage (excl. LNG)	43	13	30
Interruptible (LTIs)	111	110	99
Interconnectors	79	8	10
Totals	265	134.8	50

Source: Ofgem Centrica purchase of Rough Storage consultation

In this table we have used the total capacity of the interruptible power stations as we are considering daily swing: we recognise that 30 of the 45 days possible interruption are allocated to Transco, although Centrica can exercise

the interruption if it is prepared to bet that there will be fewer than the 30 days' Transco interruption.

On this evidence, LE Group believes that this purchase, together with Centrica's activities in other parts of the UK Gas industry value chain, will endow them with dominance in the provision of flexibility services. This includes owning over 30% of total UK storage capacity and over 50% deliverability¹, over 50% of physical system swing on a day and over 50% of day to day demand swing, not to mention their dominant share of the domestic supply market.

Even before this transaction, Centrica had access to a high share of all the swing available on the system. Admittedly, this is at least in part accounted for by their high market share of domestic supply, which drives the requirement for swing. Nevertheless, LE Group already had concerns about Centrica's ability to influence this market. This does not imply that we have any direct evidence of market abuse. Indeed, one of the problems in this area is that little of the information that would be needed to demonstrate market abuse is readily available. We believe that one possible remedy to the SLC, should the transaction gain clearance, would be the provision of much more information about Centrica's activities in the swing-related markets. This would continue until developments by other players, or the divestment of some of their activities in this market considerably diluted their market share. We do not believe however that this would fully remedy the situation arising from the acquisition and we explore other possible remedies in the remainder of our response.

Below we comment on the aspects of this transaction discussed in the consultation paper.

Access to and Availability of Rough Capacity

We are disappointed to note that Centrica does not intend to make all storage capacity available to the market on non-discriminatory terms. We believe that such an undertaking would be essential. We understand that Dynegy undertook certain guarantees in return for having more freedom in conducting bilateral agreements for storage products and recognise that this led to the ability for any storage purchaser to access an unlimited percentage of storage capacity. We would hope that in Centrica's case the cap on storage capacity is reinstated and set to not more than 20 of total storage capacity and deliverability. This would give Centrica effectively the same limitations it had when it operated the facility before the divestment from British Gas in 1996. We believe, however, that, given the propensity for prices to increase dramatically in the secondary markets, bilateral trading of Rough capacity by Centrica Rough should be limited to at most 20%. BGT/Accord should not be allowed to trade the storage bilaterally.

¹ Taking into account LNG deliverability

We note Centrica's wish to reserve 25-30% of Rough storage capacity for itself, in line with levels held previously. We believe this refers to the last storage year when it was operated by Dynegy, as, before divestment from British Gas, they were allowed to hold only 20% of total capacity. LEG would like this minimum capacity obligation to be re-instated in their undertakings and set at no more than 20% for the Rough Storage owner with another 20% cap for other market players. This would ensure that no one player can hoard capacity and artificially inflate prices.

We also note that Centrica is willing to pay market rates for this capacity as determined through the auctions. We believe that it would be preferable if Centrica were not able to bid directly in the auctions. Whilst we are happy for Centrica to pay market prices for the same product, we would not want the price to be artificially influenced by Centrica as a participant in the auctions. Centrica would indicate how much capacity they would need at any one time, in line with prevailing auction timetables and pay the weighted average price for capacity for the same product in the same period.

We believe an auction process is the best way for market participants to purchase Rough storage capacity. However, there would have to be careful consideration of the proportion of capacity that had to be made available through an auction process and how much could be left for bilateral negotiation by the separated Centrica Rough Storage. We envisage that the prices set by auction would provide the baseline for the price to be paid by Centrica, and therefore believe that a substantial volume should be made available through this process. Indeed, this appears to be Centrica's intention from their statement published on their Rough Storage bulletin board the day they purchased Rough (see Attachment to this letter). However, this was not repeated in the statement included as Appendix 1 of the Ofgem document.

It also seems appropriate that a reasonable volume should be made available on an annual basis – 20% would probably be about the right level. We would suggest that Centrica should not be able to contract for more than 60% of any volume sold by auction. Thus, for example, if 30% were sold through long term auction, then Centrica could purchase another 18% at the same price, and if 20% were sold through short-term auction, then Centrica could buy another 12% at the same price. This would leave 20% available for sale through bilaterals. However, we also think that any bilateral negotiations should only take place after the auctions – this would prevent the auction price being talked up beforehand through the process of bilateral negotiations.

There needs to be consideration of the treatment of unsold capacity. We would suggest that Centrica would not be able to use this. This would encourage realistic reserve prices and for active selling in the bilateral market of any capacity available.

Other sources of Swing

We are also aware that Centrica has a large share of beach swing, and the largest share of interruptible contracts, including almost 100% of the legacy LTI (Long Term Interruptible) contracts.

One could argue that more innovative products could come onto the market from Centrica taking up most of the UK Storage market. These products would include such things as virtual storage contracts, or more flexible interruption contracts. However, the incentives to develop these would only emerge after a long period of activity with the current storage products available.

Competition issues arising from Centrica's level of vertical Integration

We agree with Ofgem that this purchase has the potential to damage competition in the UK Gas market, not just in terms of the existing competition being eroded but also in terms of future competition from potential new market entrants. We would like also to refer to Centrica's consultation response at the time Dynergy purchased the Storage Business from BG Storage Ltd:

"Rough is effectively a monopoly and will remain so indefinitely - it has unique operational and security parameters, and will continue to fulfil a unique role in the national gas supply/demand balance, as Transco's 10-Year Statement shows. Hornsea also fulfils a monopoly role at present, and will continue to do so until comparable new physical facilities can be brought onstream, which may be later in the decade."

Effect on the wholesale markets

We believe that Centrica's position in the wholesale markets and the large proportion of the swing available will put Centrica in a position to influence wholesale prices. This could apply to both gas and electricity markets through Centrica's ability to interrupt power stations on legacy LTI contracts and to arbitrage between the markets using their own power stations.

We are not sure that undertakings can be fully effective in mitigating this problem.

Effect on the Large customer and IPP supply market.

As mentioned above, we estimate that Centrica still holds more than 65% of the large customer market and an even a larger share of the legacy LTI contracts. Their share of these types of contracts provides Centrica with 40% of the swing capability available on the day. We believe that it would be appropriate to limit interruptions under the LTI contracts to Transco interruptions only.

Effect on the domestic supply market

Centrica is the most vertically integrated company in the UK gas industry currently, with activities offshore, at the terminals, and with shipping and supplying gas to the majority of UK small and larger customers. Whilst it could be considered that owning and operating Rough storage is a natural complement to its various other activities in the market place, it is important to consider the implications this could have on competition in other parts of the value chain. For example, there would appear to be considerable scope for profits in one part of the value chain (storage, perhaps) to be used to cross-subsidise another activity (domestic supply, perhaps).

Therefore, it is the cumulative effect of Centrica's dominance in each market segment that is the problem here, and the ways in which they could interact.

Title to gas in store

We make reference to the recent debate in the gas industry surrounding the title of Gas in storage facilities in light of the demise of several gas shippers in the last year. Whilst we are happy that Rough storage is in the hands of a credit worthy company like Centrica, we hope that they will continue the drive for the Shipping community to have total assurance of holding title to their own gas injected into storage facilities. Indeed, we support BGT's modification 571 "Title to Gas in LNG facilities" and hope that they will continue the work they have done in this area which should now be facilitated by their direct ownership of such a facility.

Other Undertakings necessary

As well as the undertakings described above, we agree with Ofgem that there should be strict separation between Rough and British Gas Trading and Accord. In particular, there should be no disclosure of information relating to the use of Rough by individual market participants, and no disclosure of aggregate information that is not at the same time available to the market as a whole.

Further consultation

We welcome the fact that Ofgem is obtaining more information and continuing to undertake further analysis. We hope that this will be published as part of Ofgem's intended document on competition in the UK Gas storage market due early next year. We are particularly interested to see how Ofgem believes the current UK market for storage can be fragmented so that more competition is introduced in the near future. This will also be in line with the EU's policy on member states having storage capacity for 20% of national demand and effective competition.

Conclusions

Thus, as well as needing to put in place an undertaking to make the whole capacity available and to ring-fence information about sales of storage from trading activities, we believe that Ofgem will also need to specify carefully, on an ongoing basis, how auctions will be undertaken, what contract lengths might be appropriate, how much capacity might be subject to bilateral contracts, and how much capacity Centrica might be allowed to buy for its own shipping business. In effect, Centrica's storage business will have to become a fully separate, regulated business for as long as Centrica dominates the flexibility and supply markets. Ofgem will also have to consider carefully the potential impacts on other parts of the market, such as entry capacity, interruptible contracts and domestic supply.

I hope you will find these comments helpful but please feel free to contact John Costa on 0207 331 3753 should you have any further queries regarding our response.

Yours sincerely

Denis Linford
Group Head of Regulation

Attachment

Centrica Purchase of Dynegy Storage Limited

As you may by now have heard, Centrica plc has acquired Dynegy Storage Limited (DSL) and Dynegy Onshore Processing UK Limited. Following this acquisition Centrica now owns the Rough offshore gas storage facility and the associated pipeline and onshore processing facility at Easington.

I am writing to you today to clarify the position on the change of ownership and to assure you regarding the continuing provision of storage services to your company.

Given the importance of the Rough storage facility for the UK gas market, Centrica wishes to reassure all Rough customers that it is committed to operating and maintaining the Rough asset for the benefit all its storage customers.

Centrica currently expects that its own gas supply activities within the Group will continue to require some 25% - 30% of the annual storage capacity and intends that the balance of at least 70% of the capacity will be made available to the market. A significant proportion of this capacity will be auctioned to ensure price transparency, thereby supporting the development of competition in storage services.

Centrica intends to provide a range of innovative customer driven products and services for both short and long term storage offerings so customers will be able to choose from a range of annual and multi-year contracts.

Naturally, all existing contracts for Rough storage services will continue to be honoured by Centrica. Finally, Centrica wishes to reassure all Rough storage customers, and the market generally, that the Rough asset will be operated as a distinct company within the Centrica Group, separate and ring-fenced from the entities undertaking gas supply and storage procurement and trading activities. Effective 'Chinese walls' are in place to ensure that commercially sensitive information relating to all customer bookings or operations is protected within the storage company and is not accessible by others within the Centrica Group.

I hope this outline gives you an initial indication of our plans for this important facility. We will be providing further details in due course but, above all, we wish to assure you that we are committed to providing improved management of the commercial and operational arrangements associated with the facility for the benefit of all Rough storage customers.

Yours sincerely

Jake Ulrich
Managing Director, Centrica Energy Management Group
14 November 2002