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Rochelle Ladd
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Dear Rochelle

Centrica's completed acquisition of Dynegy Storage Limited and Dynegy Onshore Processing UK Limited – A consultation paper

Thank you for inviting us to comment on this consultation paper.

Innogy are concerned about the potential adverse effects that this acquisition may have on the UK energy market. We believe that it raises questions about the future structure of the gas market and will result in Centrica being dominant in supply and flexibility. The acquisition of Rough storage will give Centrica significant horizontal market power in storage, as Rough provides over 30% of storage deliverability and 75% of space. Centrica already possesses vertical market power through its dominant position in domestic gas supply and large gas I&C and electricity supply businesses.

The consultation paper draws the initial conclusion that, based upon preliminary analysis, the transaction will have an impact on competition. This is a view shared by Innogy and we believe that Centrica's acquisition of the Rough storage facilities has the potential to distort competition. Given Centrica's vertically integrated position, distortions could be manifested in either wholesale or retail markets.

Access to flexibility, including storage, beach swing, Bacton interconnector flows and interruptible demand contracts, allows shippers to balance their portfolios both within-day and seasonally. This is particularly important in the residential market, which is characterised by a seasonal, weather sensitive demand profile. Centrica already has access to a significant percentage of beach swing from its Morecambe Bay field, at least equivalent to the capability of Rough. Its legacy LTI contracts provide significant swing (estimated at around 12mtherms/day for up to 45 days in a year) which other shipper/suppliers have had to buy in the market. When considered alongside its other interruptible contracts and interconnector capacity, Centrica will dominate the market for flexibility.

This position needs to be considered against future developments in the gas market. The availability of high swing, southern basin gas is in decline. The ownership and possibly the operation of the Liquefied Natural Gas (LNG) storage facilities are due to change. New arrangements for exit capacity are planned from 2004 and the consequent effects on the market for interruptible demand contracts are far from clear.

Against this background of uncertainty and potentially declining availability of flexibility, we would be concerned if Centrica acted to effectively foreclose the market for flexibility and reduce other shippers' ability to acquire flexibility products. Existing shippers and new entrants will have little alternative than to procure flexibility from a major competitor. This could help to reinforce Centrica's already dominant position in the residential supply market at the expense of both existing and new suppliers.

Turning to the power market, Centrica has significant gas-fired generation assets. With their access to flexibility in the gas market, they are well placed to arbitrage between the two markets. While we have no problems in principle with this, we are concerned that enduring arrangements to monitor Centrica's behaviour in both markets are established.

It can be argued that the availability of substitutes may constrain the behaviour of existing service providers, but Centrica will have considerable market power in the short to medium terms. Since the unbundling of storage from the monopoly transporter, there have been some new entrants and modest additional storage capacity brought to market. We support diversity of storage capacity, particularly as the UK grows increasingly dependent on gas imports. In line with developments in the EU, storage may assume a much more strategic importance in the UK. Clearly, new storage projects require major investment. Potential new entrants need to be comfortable with the storage and associated markets going forward and a dominant provider should not be allowed to distort the market in order to discourage new capacity and extract economic rent.

Centrica has a major requirement for storage capacity. The way that the trading arm of Centrica accesses that capacity can create market distortions. Holding back or allocating a pre-defined quantity raises concerns about policing the terms upon which the capacity is made available. The industry would only be reassured if details were in the public domain. An alternative would be for trading to participate in any release mechanism on the same basis as other shippers. With common shareholder of both trading and storage owners, this could create perverse bidding incentives to optimise revenue flows around the group.

Although Centrica argue that industry concerns will be assuaged by "appropriate assurances" in the areas of trading and storage business ring-fencing and the availability of capacity, we believe that these are insufficient. Aggregate daily information on injection, withdrawals and inventory should be released to the market. This would help redress any perceived informational asymmetry between the Centrica trading business and the rest of the market and will reinforce the internal ring-fence. Centrica recognise industry concerns and claim that they will bring innovative products to market. Recent experience suggests that the operational requirements of Rough may limit the extent to which this is possible.

Ofgem is planning to undertake analysis to quantify the potential competition impact and inform the decision on potential remedies. We support this and would argue for a comprehensive and detailed review as, at this point, we believe that the acquisition may lead to the distortion of competition. Areas for Ofgem to consider include

quantifying the amount of flexibility available to Centrica and the rest of the market and assessing whether the LTI contracts continue to be appropriate.

Although we have identified concerns about short to medium term market power, it is the prevention of more subtle potential long-term effects that will require effective and enduring mechanisms to be established. As a minimum, Centrica should operate under a set of statutory undertakings that ensure maximum physical capacity is made available on non-discriminatory terms and full separation including systems, from all Centrica's other commercial activities. These undertakings should extend beyond 2004 and should remain in place until some of the wider developments, such as changes to the exit capacity arrangements, have been established. Once Ofgem has completed its detailed analysis, it can determine the format of any arrangements to monitor and enforce Centrica's behaviour. These should be in addition to normal competition law.

In conclusion, we believe that Centrica's acquisition of Rough represents a major structural change in the UK gas market. The impact of this change may be reflected in both wholesale and retail markets, as well as the storage market. The implications of this transaction should be fully evaluated and, where appropriate, robust controls put in place.

We would be happy to discuss these matters further.

Yours sincerely

Charles Ruffell
Economic Regulation