

Ofgem Consultation Paper on the Acquisition by Centrica of Dynegy Storage Limited and Dynegy Onshore Processing UK Limited

Centrica's Response

1. Introduction

Centrica has previously set out the reasons for the acquisition of Dynegy's Rough storage facility in the Appendix to Ofgem's consultation document. In brief, Centrica believes its ownership of this important UK gas storage asset will bring improved safety and efficiency of operation of the facility, utilising Centrica's proven offshore experience at Morecambe and Barrow; and remove recent uncertainty over the future of the asset and its contribution to UK security of supply against a forecast requirement for increased storage and other sources of flexibility.

We have carefully considered the points raised in the Ofgem consultation paper and Ofgem's initial view that Centrica's ownership of Rough leads to a substantial lessening of competition. Moreover, we note Ofgem's view that it is not yet in a position to state whether the perceived effects on competition could be fully remedied by undertakings in lieu of a reference to the Competition Commission.

Centrica's own analysis has considered the issues raised and the horizontal and vertical effects of the transaction. Based on the analysis to date, we continue to believe that an appropriate set of undertakings can be put in place to address the perceived problems, thus avoiding the need for a reference to the Competition Commission. In this respect, our thinking on the form and nature of the undertakings has moved on since the initial draft undertakings submitted to Ofgem in November and which, in outline, were included in the Centrica views in the Appendix to the consultation document.

Separately, we are currently in the period when most storage bookings are made for the storage year ahead, commencing in May. There is therefore a need to ensure that capacity in Rough can continue to be made available to the market and Centrica is committed to doing this in a manner which meets the needs of storage customers but without pre-empting the nature of any undertakings which may ultimately be agreed. To that effect, Centrica has agreed with Ofgem to make capacity available to storage customers on the basis of bilateral arrangements and auctions for the storage year 2003/4 on the basis of the undertakings given by Dynegy. Requests from customers for storage bookings beyond 2003/4 will not be accepted until the relevant regulatory position is clear.

This paper analyses the horizontal and vertical effects and the extent to which there is a lessening of competition arising through the ownership of Rough by Centrica as well as the concerns raised by Ofgem in its consultation paper. It then considers the basis on which Centrica believes capacity in Rough should be made available to the market, the appropriate sales process for storage rights, and how Centrica's own supply business should get access to capacity in Rough. The form of undertakings which Centrica believes are appropriate to deal with these issues is outlined in this paper. The paper also addresses several other concerns raised by Ofgem in Chapter 7 of the consultation document.

2. General Market Competitiveness

It is important to recognise at the outset that retail and wholesale competition in both the gas and electricity markets is now well established. This is confirmed by Ofgem's

own competitive market reviews, the removal of all supply price controls from suppliers as from April 2002, and the market's resilience to recent company failures and withdrawals from the UK gas market. In parallel there has been a process of new market entry in both gas and electricity, though mainly in gas, followed by some market consolidation. Currently, the market comprises many producers and affiliates, traders in the wholesale gas market and around 6 large players in the downstream domestic retail markets and several additional smaller players in the non-domestic markets, some of whom are large international players with their own upstream and downstream interests in the UK.

As a result of all these developments to date in the competitive energy markets, retail customers have benefited substantially from increased choice, lower prices, and improved standards of service.

More recently, Centrica has been able to secure contracts for long term gas imports from Norway and the Netherlands at UK market related gas market prices and bringing with it new infrastructure development to enhance longer term security of supply for the market as a whole.

We believe it is important that Centrica's acquisition of Rough is seen against this broader background, and that the particular competition concerns which have been raised by Ofgem as potentially arising from the change in ownership are the key areas of consideration as part of this process.

3. Rough - Competition Issues

There are two aspects of the ownership and operation of Rough by Centrica, which can be described as the horizontal and vertical issues arising from the acquisition. In either case, we believe that it is essential to consider precisely what has changed as a result of Centrica's acquisition of the facility and for that to be the focus of the consideration.

In purely horizontal terms, Centrica (through Centrica Storage Limited) is now the owner of the Rough storage facility and, as such, has an incentive to maximise storage profits. In this respect, it is important to note that Centrica's incentive is no different to any other owner of a storage facility and that this is unchanged by the acquisition (and hence ownership) by Centrica of Rough. As a horizontal issue, this incentive exists for any owner of the Rough field, whether this is BG plc, Dynegy, Centrica or another owner. The owner has an incentive to sell the product (i.e. rights to storage), in such a way that its total storage profits are maximised. In Ofgem's past reviews, it has concluded that the principal issue here is to ensure that capacity is not withheld and, moreover, the capacity available to the market is maximised. Centrica is supportive of that position.

It is Centrica's view that the ability to raise profits by increasing the price (or reducing the supply) of storage capacity at Rough is constrained by the existence of other sources of flexibility. Ofgem alludes to these other sources in its consultation paper. Notwithstanding the effectiveness of these constraints, if concerns remain over the potential ability of Centrica to earn excessive profits, it is possible to address those concerns through suitable undertakings regarding the ongoing availability of Rough capacity and/or the method of selling such capacity. To the extent that any such concerns arise from horizontal issues, the position is little different for any owner and therefore undertakings given by previous owners of Rough in the past in this regard can be taken as a basis for those put in place by Centrica.

Turning to vertical issues, storage may be regarded as one of many inputs into the downstream supply business. In this context Centrica (through its supply business) is a buyer of Rough storage rights and a downstream competitor of other holders of such rights. Viewed from this perspective, Centrica now owns an input that is likely to be required (at least in part) by some players in the gas supply market. Consequently, there may be a concern that Centrica would wish to use its ownership of Rough to raise the costs of its rivals (and potential rivals) in the downstream gas supply market.

Such an incentive is, in our view, likely to be constrained by the availability of alternative sources of flexibility. However, if it were not, then there may be concerns that Centrica could use its ownership of Rough to disadvantage its downstream rivals by raising the price of storage (e.g. by setting a high reserve price in an auction) or by withholding capacity from sale. In this respect, whilst the vertical incentive should be regarded as distinct from the horizontal one, its effect on the sales of capacity may be similar. Thus, in the same way, the ability for Centrica to take action in this regard can be effectively constrained by limiting the ability of Centrica (or others) to withhold capacity. Furthermore, any sensitivities in downstream competition can be protected by an effective secondary market and a mechanism for ensuring that a proportion of capacity is available on one year terms. All these areas are covered by the undertakings outlined in this response and we believe ease the concerns expressed by Ofgem in paragraphs 7.12 and 7.13 of the consultation paper.

It is important to consider the extent to which the acquisition has changed anything by comparing the current situation (with Centrica as the owner of Rough) with the pre-acquisition situation (where Centrica participated as a significant buyer of storage rights at Rough). Focussing on the vertical issues alone (i.e. ignoring horizontal profit maximisation), the distinction has far less significance than might at first appear. Even acting purely as a *non-integrated buyer* Centrica may have been thought to have had a motive to obtain additional storage rights, not only to meet its own operational requirements but also in order to withhold storage from (or raise the price of storage to) its competitors in gas supply. Centrica has never contemplated that such a tactic would be commercially viable, let alone feasible given use it or lose it mechanisms (UIOLI) in the standard storage contract (coupled with wider anti-competitive and regulatory constraints).

There are ways to ensure that the acquisition will not operate to increase Centrica's position in Rough storage overall and, as we accept the principles of third party access and capacity sales, we confirm our willingness to give undertakings to that effect.

Ofgem has expressed some concern regarding a lack of incentive to innovate and distorted incentives to invest which it believes may arise from Centrica's ownership of Rough. As the swing from indigenous UK produced gas reduces and the UK becomes more reliant on lower swing UKCS and imported gas, there will be an increasing requirement for UK storage. This projected increase in demand for storage and other flexibility sources has prompted third party competitors to develop other storage sites (e.g. Byley, Aldborough, Hole House Farm and Fleetwood) and the owners of the Bacton Interconnector to increase reverse flow capacity of the pipeline by approximately 100%. Centrica believes its incentives to invest meet this demand are no different to its competitors. Furthermore, the introduction of new sources of flexibility will serve to ensure that Centrica's utilisation and operation of Rough will be subject to increasing competitive constraint. Whilst it is still too soon after the acquisition to understand fully the scope and efficacy of any such work,

Centrica is happy to present to Ofgem a review of its findings in relation to potential projects relating to Rough which were considered by Dynegy (and BG before it), following appraisal by Centrica.

In addition to competition concerns, Ofgem has outlined its information concerns (as noted in paragraphs 7.3, 7.17 and 7.22 of the consultation paper) potentially arising from the fact that Centrica is active in other parts of the gas market (as other, previous owners of Rough have been) where information about Rough could be commercially significant. Again, the issue has been considered and addressed by undertakings before and Centrica is willing to offer an undertaking following closely those that have been given before in this regard. Centrica sees no reason why such barriers should not be effective given the experience of other companies and indeed, British Gas pre-demerger. As Ofgem is aware, since the acquisition (and even during the due diligence process), Centrica has ensured the storage information is ring fenced from the supply business.

As a starting point, we have worked on the basis that the undertakings given by Dynegy for their acquisition of Rough in 2001 were satisfactory. The present consideration should thus focus on the changes to the current regime which are necessitated by the fact that Centrica now owns Rough (taking account of Centrica as a buyer of storage rights and a downstream competitor of other gas suppliers). We therefore propose a series of possible undertakings to be given by Centrica based on those agreed by Ofgem and the OFT with Dynegy, but enhanced to address valid Centrica-specific concerns.

Centrica envisages that the undertakings should run for a period of 5 years (until the end of April 2008) - but should be reviewable after Ofgem's review of the storage market in 2003 and annually thereafter.

4. Nature of Undertakings Proposed

Capacity Availability

In line with previous undertakings to this effect given by previous owners of the Rough (and Hornsea) facility, Centrica is prepared to undertake that the maximum physical capacity of the Rough storage facility as defined in previous BG and Dynegy undertakings (and as set out below) will be available to the market for storage use on a non-discriminatory basis.

Injection Capacity	160 GWh/day ¹
Space Capacity	30,300 GWh
Withdrawal Capacity	455 GWh/day

This undertaking (operating with others outlined below) seeks to reduce any horizontal and vertical concerns of withholding capacity to raise prices.

Centrica is also prepared to undertake that, where additional space, injection or withdrawal capacity is created as a result of work carried out to expand the Rough storage facility for the benefit of customers, it will be made available to the market and a revision would accordingly be made to the maximum physical capacity figures.

¹ Subject to the Daily Injection Adjustment Factor as described in the Storage Services Contract.

Sales of Capacity

To the extent that the horizontal issue outlined above occurs irrespective of the identity of the owner, a change in ownership of Rough (and particularly ownership by Centrica) does not, of itself, necessitate a change in the manner of conducting sales of capacity in Rough.

In this respect, Centrica is prepared to undertake to continue to operate the existing Storage Services Contract (which is due to expire at the end of April 2004) until the end of April 2008. This has a number of advantages:

- Buyers of storage are familiar with its terms – which were, in any event, concluded after a thorough negotiation and consultation process
- The terms of the contract provide for sales by various means throughout the year (e.g. auctions, tenders or bilateral negotiations) and this flexible approach is welcomed by customers
- The terms of the contract provide for a mechanism whereby unused capacity (space, injection, and deliverability) is available for use on an interruptible basis by other customers of the facility (UIOLI) and,
- All customers, including affiliates and owners, are treated equally in respect of operations and issues such as information flows and confidentiality.

Centrica will undertake that a proportion of the capacity in Rough will be made available on one year terms to ensure that capacity will be available on the primary market each year. This is intended to facilitate entry into this aspect of the UK gas market and may help promote more rapid development of new supplies and products.

Capacity for Centrica as a Storage User

Centrica considers that the issue of how it obtains capacity in Rough can be appropriately covered in one or more undertakings. This will necessitate consideration of any vertical concerns that may be held to arise, as discussed above.

Consistent with the undertaking to make the maximum physical capacity available to the market, Centrica would buy its capacity in competition with other users of the facility. In order to allay competition concerns particularly those linked to the downstream supply market, Centrica would be prepared to accept a limit on the amount of capacity it would be able to acquire by participation in the primary market for Rough capacity. Based on past, existing and forecast use of storage, Centrica envisages an undertaking to limit its participation to 30% of Rough capacity. In this way, the incentives and ability for Centrica's supply business to bid up the price for other users and thereby benefit Centrica's storage business are effectively removed. The UIOLI regime protects against the 30% simply being withheld from the market by Centrica's supply arm rather than being used for storage purposes.

Third parties may be concerned, however, that Centrica's participation in the primary market for Rough capacity (even if subject to a percentage cap as proposed) will distort the bidding in some way and enable it to gain an advantage, either as Rough owner or as a supply competitor downstream.

Although Centrica believes that participation in the primary market with capacity limitation ought to allay other storage customers' concerns, it would also accept as an alternative solution (which was referred to in the Centrica paper appearing in the Ofgem consultation document) that Centrica's supply business would be entitled to acquire a fixed proportion of Rough capacity, with the remainder sold to third parties in the primary market. To the extent that Centrica desired storage capacity over and above this threshold, it would be required to purchase it in the secondary market. Again, Centrica would propose the fixed proportion reserved for its supply business be set at 30% of total Rough capacity.

In this case, Centrica's non-participation in the primary sales process would remove any concern over bidding up the price for other users. The price for the reserved Centrica capacity would be set by reference to the average price derived from the one year sales process. Again, the UIOLI rules would protect the market from Centrica leaving booked capacity unused.

Anti-hoarding Measures

Any reservation of capacity, as suggested, should be accompanied by effective UIOLI rules. But, in order to alleviate concerns over any player choosing to buy excess capacity, it should continue to apply to all users of Rough. The existing Storage Services Contract, which Centrica would propose to extend until 2008, will address this issue as it already incorporates robust UIOLI rules.

One Year Capacity

Centrica recognises the continuing importance of allowing new entrants (and expanding players) access to storage rights and is prepared to undertake to continue to make at least 20% of the maximum physical capacity available to the market every year on a one-year basis.

Secondary Trading

Whatever the form of the primary selling mechanism, Centrica accepts the importance of secondary trading to ensure the allocation of storage rights is efficient, not only when the primary sale takes place but at all times thereafter. Centrica would undertake to continue to facilitate a secondary market in both bundled and unbundled storage rights.

Ring-fencing

Centrica recognises the commercial sensitivity of the information about customers' bookings and requirements for the use of the Rough storage facility and has already put in place a ring fence, and associated Code of Conduct, around Centrica storage's commercial (customer facing) activities to protect such information and ensure it is not disclosed outside that area. The employees concerned are not unused to operating within a ring fence in this manner. This will overcome any concerns that information gained by Centrica storage will be used to benefit Centrica as a trader or supplier (as outlined by Ofgem in the consultation paper – paragraphs 7.3 and 7.22).

The Code of Conduct which has been put in place recognises that some of the day to day information about the operation of the off-shore facility and the associated terminal (eg aggregate nominations) could be of short term benefit to staff engaged in gas trading. Therefore identified operations staff working on Rough have been

designated as persons who must not pass any potentially sensitive operational information to other parts of the business.

We do not believe that Centrica's operation of Rough and Morecambe will produce a potentially distorting influence on storage or on gas prices - the introduction of an information compliance regime and the ring fence around the market information and sensitive operational information has been designed to protect the sensitive data and ensure that it is not disclosed such that the trading and supply parts of the Centrica Group can gain an unfair commercial advantage.

5. Addressing Further Issues Arising from the Consultation Paper

The Ofgem consultation paper mentions a number of further issues which have not yet been specifically considered in this response.

The perception of Centrica's position – paragraph 7.13

We believe that undertakings along the lines outlined in this paper will operate to ensure that there will continue to be non-discriminatory access to Rough at reasonable prices and on terms that are designed specifically to protect domestic gas supply. Furthermore, the operation of the ring fence will underline and serve to demonstrate the separation between the storage business and the rest of Centrica (which must be key to countering any perception issues). Finally, the players in the downstream gas supply market are currently significant players in their own right, active in related upstream and downstream markets both in the UK and, in some cases, continental Europe. We do not believe that this is an issue given the competitive nature of the market and the offered undertakings – the key concern must be focussed on conduct.

Removal of Centrica as a significant purchaser of storage services – paragraph 7.14

Ofgem suggests that Centrica's role as a major purchaser of Rough storage rights may have constrained Dynegy's activities and was therefore in some way of benefit to other buyers. However, Centrica is unaware of any preferential treatment/terms being offered to larger customers by either BG or Dynegy and in any event, the regulatory requirements under which storage has operated to date is one of non-discriminatory access.

Gas supply – paragraph 7

Any concerns in the downstream market can only possibly arise if Centrica's ownership of Rough is likely to demonstrate the horizontal and vertical effects described above – that is, if the price of storage is to be pushed up by horizontal and vertical incentives. As we have already explained, the proposed undertaking to either cap Centrica supply's storage capacity or the alternative of reserving capacity on a UIOLI basis would both address this particular concern. Moreover, given the wider market for competition in sources of flexibility, we believe that there is sufficient competition to allay any horizontal concerns, as described above.

Electricity supply - paragraph 7.15

Compared with gas supply, the linkage with electricity supply is one step further removed from Centrica's ownership of Rough. As Centrica does not believe that any

increase in storage prices will arise as a result of the transaction, due to the commitments offered, and therefore does not believe that there would be any impact on the downstream gas market, there cannot be any impact on the electricity market through dual fuel offerings.

Electricity generation (para 7.16)

Centrica accepts that efficient arbitrage between gas and electricity markets is one potential source of constraint on the pricing of storage at Rough. Ofgem appears to be concerned that Centrica may be able to take advantage of arbitrage opportunities between the gas and electricity markets by exercising its seller's interruption rights or effectively by withholding capacity in flexible sources from the market. Centrica, prior to its ownership of Rough, already had the ability to undertake efficient arbitrage – to that extent nothing has changed post acquisition and the proposed undertaking relating to separation and ring fencing information (which is already in place in practice), will operate to ensure that Centrica is not in a better position to do so now compared to its previous position.

With the generation market in serious over-supply with a likelihood of excess capacity now and for the next 5 years or so, in Centrica's view, there is little reason for concern over the possible withdrawal of some gas-fired generation at certain times in order to arbitrage the gas market.

6. Conclusion

Centrica believes that the proposed undertakings outlined above satisfactorily address both the competition and informational issues which form the basis of issues raised by Ofgem. Once these are addressed, Centrica believes that the position is no different to that prior to Centrica's ownership of Rough. Given that these matters were considered capable of remedy through undertakings in the past, it is Centrica's view that measures starting from the same basis and extended accordingly will be sufficient to address any issues arising from this acquisition.

Regulatory Affairs
Centrica plc